

## Support Your Family but Leave out Uncle Sam: a Call for Federal Gift Tax Reform

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# SUPPORT YOUR FAMILY BUT LEAVE OUT UNCLE SAM: A CALL FOR FEDERAL GIFT TAX REFORM

ROBERT G. POPOVICH\*

## INTRODUCTION

From the time they are old enough to understand, we teach our children to love and care for one another. God commands "honor thy father and thy mother"<sup>1</sup> and "love thy neighbor as thyself."<sup>2</sup> Yet if carrying out these obligations requires financial expenditures, the Internal Revenue Service (IRS) may promulgate an Eleventh Commandment: Pay thy gift taxes! Transfers of money or property for the support of another, if based solely on a fundamental sense of moral obligation, are technically "gifts" subject to gift tax.<sup>3</sup>

Surely a concept as complex and often times convoluted as the federal gift tax must apply only to transactions that are carefully

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1. *Exodus* 20:12 (New King James).

2. *Leviticus* 20:18 (New King James).

3. The Internal Revenue Code imposes a tax on transfers of property made during an individual's lifetime minus certain exclusions and deductions. I.R.C. §§ 2501-2524 (1988 & Supp. V 1993); see also *infra* notes 25-34 and accompanying text. The tax is assessed on a cumulative basis with rates beginning at 18% and escalating to a 55% maximum. I.R.C. § 2502 (1988) (referring to the rates provided in I.R.C. § 2001 (1988)); see also *infra* notes 29-31 and accompanying text.

In addition to the federal tax, many states impose some form of a death tax. Traditionally, the form of death taxation used by the states was the inheritance tax. BORIS I. BITTKER & ELIAS CLARK, *FEDERAL ESTATE AND GIFT TAXATION* 11 (6th ed. 1990). Unlike the estate tax, which is levied on the donor's privilege of transferring wealth, the inheritance tax is levied on the donee's privilege of receiving property from the decedent. *Id.* Most states have moved away from the inheritance tax and the modern trend is to impose a "pick-up" tax in the maximum amount allowed under I.R.C. § 2011 as a credit for state death taxes against the federal estate tax. *Id.* n.23. At present, 28 states impose a pick-up tax, 18 states use a combination of the inheritance tax and estate tax, and 5 states rely solely on the estate tax. John M. Janiga & Louis S. Harrison, *The Case for Retention of the State Death Tax Credit in the Federal Transfer Tax Scheme: "Just Say No" to a Deduction*, 21 *PEPP. L. REV.* 695, 701-02 (1994). Although states continue to impose these death taxes, the money received constitutes only a small fraction of overall revenue. BITTKER & CLARK, *supra*, at 2. For example, in 1987 the states, in the aggregate, collected \$247 billion in total taxes, but only \$3 billion (a little more than 1%) came from death and gift taxes combined. *Id.*

crafted as part of an individual's estate or financial plan. Would not such a tax apply only to the megawealthy so as to prevent them from escaping estate tax liability? There is no implication of the gift tax system to everyday people facing everyday scenarios—or is there?

A son or daughter is entering college. In view of their child's accomplishments, the proud parents are devoted to furthering their child's education and, despite the high cost of such an endeavor, provide meals, housing, and other financial assistance to their child. The IRS most likely has a "winner" here—the proud parents have ostensibly made gifts that may subject them to federal gift taxes.<sup>4</sup>

Collegiate parents are not the only individuals who may unknowingly wander into the lair of the federal gift tax. For example, a devoted son, daughter, or other relative provides in-home care for an elderly parent suffering the devastation of Alzheimer's disease. Here too, the caregiver, while exhibiting the honorable human traits of care and compassion, may be burdened with gift tax liability.<sup>5</sup>

Congress could not possibly have intended the gift tax statutes to burden individuals making these types of support transfers. Even the IRS, while the champion of evil in the minds of the general public, would not impose a gift tax on these types of transfers—or would it? Take the case of a forty-three-year-old woman afflicted with severe cerebral palsy. Totally disabled from the waist down with limited use of only one arm, capable of only limited communication, and requiring around-the-clock nursing care, she was left with no means of support or care after the death of her mother.<sup>6</sup> Her brother, also afflicted with cerebral palsy and partially disabled, took care of his sister by providing food, shelter, and medical expenses.<sup>7</sup> Understandably, the faithful and compassionate brother did not consider that his support, pursuant to his mother's dying wish and compelled out of moral obli-

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4. See, e.g., Treas. Reg. § 25.2503-6(b)(2) (1984) (demonstrating the exclusion for certain qualified transfers for tuition expenses).

5. The IRS has stated, for example, that income from a trust established for the benefit of the grantor's parents constitutes a taxable gift. Priv. Ltr. Rul. 82-25-091 (Mar. 25, 1982). However, the IRS also recognized that there is no gift "to the extent that current income of the trust is applied or distributed in satisfaction of the grantor's legal obligation to support or maintain his parents." *Id.*; see also *infra* notes 73-79 and accompanying text.

6. Tech. Adv. Mem. 81-35-032 (June 1, 1981); see also Gen. Couns. Mem. 38,702 (Apr. 28, 1981) (discussing whether payments made by the decedent during her life for the medical expenses and support of her adult handicapped children are gifts for federal gift tax purposes).

7. Tech. Adv. Mem. 81-35-032. The mother's will left the entire residue of her estate to her son with the following notation: "I intentionally make no provision herein for my daughter . . . for the reason that I am sure that her support, comfort and well-being will be adequately and properly provided for by her . . . brother." *Id.*

gation, would have gift tax ramifications. The IRS, on the other hand, did consider the gift tax ramifications of this support and classified these expenditures as gifts for gift tax purposes, thereby subjecting the brother to gift tax liability.<sup>8</sup> The IRS reasoned that in order for support payments to escape the gift tax, there must be a legal duty to support rather than a purely moral obligation.<sup>9</sup> Because the brother's support was not pursuant to any legal obligation, but was instead motivated by love and a moral obligation, the gift tax hatchet fell.

In light of the recent emphasis by political leaders on promoting traditional "family values,"<sup>10</sup> the idea that such support might be subject to gift tax seems contrary to public policy and, furthermore, poses practical concerns. First and foremost, it is not generally understood by the layman that such expenditures may result in taxable gifts.<sup>11</sup> This leads to mass, albeit unintentional, noncompliance with the gift tax statutes.<sup>12</sup> Public ignorance and consequential noncompliance, however, do not seem to have prompted aggressive enforcement efforts by the IRS. Perhaps this is because of the minimal potential cur-

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8. *Id.* In addition to the expenditures by the son, support given to the disabled daughter by the parents before they died also amounted to transfers subject to gift tax. *Id.* It should be noted that current law provides a limited gift tax exclusion for certain medical payments made on behalf of another. See *infra* notes 147-150 and accompanying text.

9. The IRS noted that property transferred by a taxpayer to discharge his legal obligation to support his minor children is a transfer for adequate and full consideration and is not taxable as a gift. Tech. Adv. Mem. 81-35-032. "The duty of support, however, must be a legally enforceable obligation rather than a purely moral obligation." *Id.*; see *infra* notes 73-79 and accompanying text. In this situation it was determined that under New York law, there was no legal duty of support. Tech. Adv. Mem. 81-35-032.

10. The political nature of this concept was illustrated in 1992, when Vice President Dan Quayle sparred with television actress Candice Bergen (portraying newscaster Murphy Brown as a single mother) over preserving the traditional two-parent family unit. Family values have even permeated the tax area: "Higher taxes have been tearing at the fabric of the American family, and [the legislature] can't just focus on economic arguments and ignore family values." Richard Kirkland, *Today's GOP*, FORTUNE, Feb. 6, 1995, at 50 (quoting Ralph Reed, executive director of the Christian Coalition).

11. See Bernard V. Lentz et al., *Prospective Federal Taxation: A Panel Discussion*, 31 N.Y.U. INST. ON FED. TAX. 1637, 1669 (1973) ("At least I know of very few clients who have come to me suggesting that there might be a gift tax problem in this area. I think it is probably a fair assumption that there are relatively few people who think these . . . [support-type] transfers, are taxable gifts.").

The term "taxable gift" has a specific meaning for purposes of the gift tax and it reflects certain exclusions and deductions. See *infra* notes 25-31 and accompanying text. Many otherwise taxable support-type transfers will not, in fact, result in taxable gifts because of the allowance of a \$10,000 per year, per transferee annual exclusion in computing taxable gifts. I.R.C. § 2503 (1988). See *infra* note 33.

12. The Supreme Court has recognized the heavy burden on the taxpayer due to the fact that "the tax system is basically one of self-assessment, complexities and uncertainties in the gift taxation area." *Dickman v. Commissioner*, 465 U.S. 330, 347 (1984) (Powell, J., dissenting).

rent penalty,<sup>13</sup> or perhaps out of fear over unjustifiably wading into the waters of public outcry.

Caught between Scylla and Charybdis are the tax advisors, who are left in a predicament as to how to advise their clients. Should they instruct their clients to fill out a gift tax return and pay tax for any support expenditures arising from a moral obligation, or should they (or can they) intentionally fail to inquire about their client's support expenditures and hope for a lack of IRS enforcement? Aside from this practical and ethical issue from the advisor's perspective, subjecting transfers for the support of others to a gift tax violates the core principles of human compassion<sup>14</sup> and does not promote the general policy for the imposition of gift taxes.

Although commentators have suggested that the law in this area has been "appropriately quiet," and that it is unsuitable for legislative change, so that "[p]urists simply should contain any urge to remove this rough edge in gift tax administration,"<sup>15</sup> it is undoubtedly an area of confusion that should be addressed. This Article focuses on the deficiencies in current federal gift tax provisions with respect to transfers of money and property for the support of others. Part I of this Article explains the general structure of the federal gift tax and discusses the basic concepts of what constitutes a gift, specifically, the role that consideration plays in determining whether the transfer of a taxable gift has occurred.<sup>16</sup> Part II focuses on expenditures for another's support, distinguishing financial support for the discharge of one's legal obligations, which is not a taxable gift, from support arising out of moral obligation, which is taxable.<sup>17</sup> Part III discusses the concerns created by the current law, including the ethical issues of counsel and advising.<sup>18</sup> Part IV concludes with possible solutions to

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13. Milton L. Ray, *The Transfer-for-Consumption Problem: Support and the Gift Tax*, 59 OR. L. REV. 425, 426-27, 444 (1981). Mere failure to file a gift tax return due to neglect results in a penalty of 5% of the tax due for each month past due, with a maximum of 25%. *Id.* at 445.

14. In granting tax benefits for individuals who make gifts to charity, the IRS itself has indirectly acknowledged that transfers made out of human compassion and moral obligation should not be taxed. Tax deductions for transfers to charity are provided by the Code in the areas of gift tax, I.R.C. § 2522(a) (1988), estate tax, *id.* § 2055(a), and income tax, *id.* § 170(a), (b)(1). Indeed, it is difficult to articulate why support to a public charity deserves a tax break, but transfers to support a needy friend or relative are taxable. See *infra* notes 140-146 and accompanying text.

15. John L. Peschel, *Recent Developments in Estate Planning*, MAJOR TAX PLAN. ¶ 1300, 1304.1, at 13-32 (1982).

16. See *infra* notes 20-67 and accompanying text.

17. See *infra* notes 68-108 and accompanying text.

18. See *infra* notes 109-139 and accompanying text.

the problem, including a "transfer-for-consumption" proposal, which would exclude expenditures for the reasonable support of others.<sup>19</sup>

## I. THE BASICS OF THE GIFT TAX

### A. *Gift Tax Framework*

A tax on the privilege of transferring wealth from one individual to another was first enacted in 1916 in the form of an estate or death transfer tax.<sup>20</sup> The concept of such an estate tax, while arguably draconian, is simple: Assess a tax based on the value of the decedent's assets that are transferred to the beneficiaries upon such decedent's death.<sup>21</sup> Although ostensibly a revenue-raiser for World War I, the enactment of the estate tax was more likely prompted by a growing concern over the large accumulation of wealth in a small number of families—the Fords, Rockefellers, and Carnegies of the day would no longer perpetuate great wealth from generation to generation without some diminution by tax.<sup>22</sup> In the context of such a tax, the use of the phrase "the privilege of transferring wealth" is derived from the fact that the estate tax is primarily the obligation of the transferor/decedent (more appropriately the decedent's estate),<sup>23</sup> and not that of the transferee/beneficiary.

Although the 1916 legislation made testamentary dispositions of assets subject to tax, this original transfer tax left available an alterna-

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19. See *infra* notes 140-199 and accompanying text.

20. Edward J. McCaffey, *The Uneasy Case for Wealth Transfer Taxation*, 104 YALE L.J. 283, 284 (1994). Due to the unequal distribution of privately held wealth, scholarly support for some sort of a wealth transfer tax has remained strong over the years. *Id.* Unlike the ever-changing income tax system, today's estate tax remains quite similar to the initial 1916 structure. *Id.* at 284-85.

21. The current Internal Revenue Code provides that a tax is imposed on "the transfer of the taxable estate of every decedent who is a citizen or resident of the United States." I.R.C. § 2001 (1988). The value of the decedent's gross estate includes "the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated" in which the decedent had an interest. *Id.* § 2031; see also *id.* § 2033. The Code also allows for certain deductions from the estate including bequests to charity, *id.* § 2055, claims, debts, and expenses of the estate, *id.* § 2053, casualty losses, *id.* § 2054, and marital transfers, *id.* § 2056. In addition, the Code provides one lifetime unified credit in the amount of \$192,800 that applies first to taxable inter vivos gifts, and the remainder to the taxable estate. *Id.* §§ 2010, 2505. Although the concept of such an estate tax may be conceptually simple, there are now many detailed provisions that make determination of the tax liability rather complex.

22. The estate of Mrs. Andrew Carnegie illustrates the potential tax liability that wealthy individuals face. Out of her \$20.5 million estate, \$2.5 million was left to charity and \$11.5 million (over half of the total estate!) went for the payment of estate taxes. BITTKER & CLARK, *supra* note 3, at 7.

23. I.R.C. § 2002 (1988 & Supp. V 1993) provides that the estate tax imposed "shall be paid by the executor [of the estate]."

tive by which individuals could avoid tax on the transfer of wealth: inter vivos gifts. No significant statutory roadblocks prevented the diminution of an individual's estate by the transfer of property before death. The estate tax, by its very nature, applied only to a decedent's testamentary transfers and, except in very limited provisions, had no application to gifts made during an individual's life.<sup>24</sup>

To close this gap, a gift tax—a toll on the privilege of transferring wealth during an individual's life—was enacted in 1932.<sup>25</sup> Transfers

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24. The 1916 estate tax sought to impose a tax on lifetime transfers where the donor did not intend for the donee to receive possession or enjoyment of the property until after the donor's death. Mark R. Siegel, *Retained Possession and Enjoyment: Searching Out the Reality for Residential Transfers*, 24 Sw. U. L. REV. 81, 83 (1994). Thus, inter vivos gifts made in an attempt to avoid the estate tax when the donor effectively retained a life estate in the property were subject to the estate tax under the 1916 postponed possession and enjoyment clause. *Id.*; Revenue Act of 1916, Pub. L. No. 64-271, ch. 463, § 202, 39 Stat. 756, 777. The clause called for a tax "[t]o the extent of any interest therein of which the decedent has at any time made a transfer . . . in contemplation of or intended to take effect in possession or enjoyment at or after his death." § 202, 39 Stat. at 777.

Despite the enactment of the gift tax, the current Code still provides exceptions to the general rule that the estate tax applies only to a decedent's testamentary transfers. First, if the transferor kept sufficient power to alter, amend, revoke, or terminate an inter vivos transfer, the amount over which the grantor retained the power is pulled into the taxable estate. I.R.C. § 2038(a) (1988). For example, if the grantor sets up an irrevocable trust but retains the power to accumulate income or make early distributions to the designated beneficiary, § 2038 will cause inclusion in the grantor's estate. *Id.* Second, if the grantor makes a lifetime transfer but retains a life interest in the income or the right to use the property, the entire value of the property transferred will be included in the grantor's taxable estate. *Id.* § 2036(a). This inclusion arose from the 1916 postponed possession and enjoyment clause. § 202, 39 Stat. at 777. Thus, if the grantor transfers interest in an apartment to his child but continues to live there until his death, the grantor has retained an effective life estate and the entire amount of the apartment is subject to estate tax. One of the more complex examples of the lifetime transfers that may be included in the decedent's estate occurs if the beneficiary is required to outlive the grantor before he can obtain possession of the property, and the grantor holds a reversionary interest of more than 5% of the property transferred. I.R.C. § 2037(a) (1988). To illustrate, Grantor sets up the following trust: "To Alex or Alex's estate as long as Grantor is alive and at Grantor's death, to Bob if Bob is still living. If Bob predeceases Grantor, the property reverts back to Grantor's estate." Because Bob's interest is contingent on surviving the grantor (and assuming it is worth more than 5% of the value of the property at the time of the transfer), and the grantor retained a reversionary interest, the value of Bob's interest is included in the grantor's taxable estate. Finally, the Code provides that any transfers that would be included under the above provisions are included in the grantor's estate if they existed within three years of the grantor's death. *Id.* § 2035. Using the above retained life estate example, if the grantor lived in the apartment until 1992 and died in 1994, the apartment is still included in the taxable estate because the relinquishment of the de facto life estate was within three years of death.

25. The government's first attempt at imposing a gift tax occurred in 1924 with a transfer tax that was assessed annually on a noncumulative basis. The taxpayer was provided with a \$50,000 annual exemption, and a \$500 annual exclusion for each donee. Revenue Act of 1924, Pub. L. No. 68-176, § 321(a)(1)-(3), 43 Stat. 253, 314. Because of the large annual exemption, a taxpayer could easily avoid both estate and gift taxes by making inter

at death remained within the domain of the estate tax, while lifetime transfers came within the scope of the gift tax. Thus, the gift tax served as a backstop to the estate tax<sup>26</sup> to prevent the tax-free diminution of an individual's estate.<sup>27</sup> Again, the term "privilege" is aptly applied to the transfer of wealth covered by the gift tax because the transferor/donor, and not the transferee/donee, is primarily liable for the tax.<sup>28</sup>

The basic framework of the gift tax is, like that of the estate tax, rather simple. The tax is assessed on "taxable gifts" at rates ranging from eighteen to fifty-five percent.<sup>29</sup> While the gift tax is assessed on an annual basis,<sup>30</sup> it is computed on a cumulative or lifetime basis.

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vivos transfers under \$50,000 for a period of several years. John G. Steinkamp, *Common Sense and the Gift Tax Annual Exclusion*, 72 NEB. L. REV. 106, 110 (1993). In an attempt to reduce federal taxes, the 1924 gift tax was repealed in 1926. Because of an increase in federal deficits caused by the Depression, however, Congress returned to the drawing board in 1932 and enacted the antecedent to our current federal gift tax statutes. *Id.* at 110-11.

26. Without the gift tax, the estate tax "could achieve neither its social function of checking the undue concentration of wealth nor its incidental fiscal function of raising revenue." BORIS I. BITTKER & LAWRENCE M. STONE, *FEDERAL INCOME ESTATE AND GIFT TAXATION* at ix (4th ed. 1972). Congress itself noted that the gift tax "tend[s] to discourage transfers for the purpose of avoiding the estate tax." S. REP. NO. 665, 72d Cong., 1st Sess. (1932), *reprinted* in 1939-1 C.B. pt. 2, at 496, 525. No longer is a person able to make tax-free inter vivos gifts to diminish his estate. In fact, the cumulative nature of the gift tax was intended to result in a tax that approached the amount of estate tax that would have been owed if the gift had not been made. Steinkamp, *supra* note 25, at 111 (citing H.R. REP. NO. 708, 72d Cong., 1st Sess. (1932), *reprinted* in 1939-1 C.B. pt. 2, at 457, 477; S. REP. NO. 665, *supra*, *reprinted* in 1939-1 C.B. pt. 2, at 496, 525); *see also infra* note 31 and accompanying text.

27. *See* Stephen W. Schlissel & Bryan C. Skarlatos, *Some Federal Gift & Estate Tax Consequences of Support Payments and Property Settlements*, 10 J. AM. ACAD. MATRIMONIAL L. 79, 79 (1993).

28. I.R.C. § 2502(c) (1988) states that the gift tax imposed "shall be paid by the donor." A donee may become liable for payment of the donor's gift tax obligation in the event the donor fails to pay the tax when due. *Id.* § 6324(b); Treas. Reg. § 301.6324-1 (as amended in 1972). In such instances, the donee is liable to the extent of the value of the gift. I.R.C. § 6324(b); Treas. Reg. § 301.6324-1.

29. I.R.C. § 2001(c) (1988). I.R.C. § 2502 provides that the computation of gift tax is subject to the rates found in I.R.C. § 2001(c). As of 1995, the top tax bracket was 55%. As with income taxes, I.R.C. § 1, the gift tax is progressive, so the greater the gift, the greater the tax rate. For example, if Sheila made total taxable gifts in 1995 of \$80,000 (after exclusions and deductions), her gift tax liability (before credits) would be \$18,200. So, if Sheila made double the taxable gifts in 1995 for a total of \$160,000 (after exclusions and deductions), it seems logical that her gift tax liability (before credits) would double and equal \$36,400. But when computing the tax, Sheila is in a higher bracket because her taxable gifts increased. As a result, her gift tax liability (before credits) on \$160,000 of taxable gifts is actually \$42,000.

30. Any individual who makes a taxable gift in the calendar year is responsible for filing a gift tax return on or before April 15 following the close of the calendar year. I.R.C. § 6075(b)(1) (1988).



This results in the application of higher gift tax rates as more taxable gifts are made over an individual's life.<sup>31</sup>

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31. *Id.* § 2502(a)(1)-(2). The following problem illustrates the cumulative nature of the gift tax over one's lifetime. The six computational steps reflected below are explained in Treas. Reg. § 25.2502-1(a) (as amended in 1992).

In 1993 through 1995, Sheila made the following gifts:

- 1993, gifts (after exclusions and deductions) aggregating \$300,000.
- 1994, gifts (after exclusions and deductions) aggregating \$300,000.
- 1995, gifts (after exclusions and deductions) aggregating \$300,000.

*1993 Gift Tax Computation*

*Step One:* taxable gifts in current year (1993) = \$300,000.

*Step Two:* aggregate taxable gifts from prior years (after June 6, 1932) = 0.

*Step Three:* aggregate lifetime taxable gifts (sum of steps one and two) = \$300,000.

*Step Four:* tentative tax on aggregate lifetime gifts = \$87,800.

*Step Five:* tax on prior years' taxable gifts (from step two) = 0.

*Step Six:* tax on current year's taxable gifts (tax in step four less tax in step five) = \$87,800 - 0 = \$87,800. This is the amount of tax before application of any credits (see below).

*1994 Gift Tax Computation*

*Step One:* taxable gifts in current year (1994) = \$300,000.

*Step Two:* aggregate taxable gifts from prior years (after June 6, 1932) = \$300,000.

*Step Three:* aggregate lifetime taxable gifts (sum of steps one and two) = \$600,000.

*Step Four:* tentative tax on aggregate lifetime gifts = \$192,800.

*Step Five:* tax on prior years' taxable gifts (\$300,000 from step two) = \$87,800.

*Step Six:* tax on current year's taxable gifts (tax in step four less tax in step five) = \$192,800 - 87,800 = \$105,000. This is the amount of tax before application of any credits (see below).

*1995 Gift Tax Computation*

*Step One:* taxable gifts in current year (1995) = \$300,000.

*Step Two:* aggregate taxable gifts from prior years (after June 6, 1932) = \$600,000.

*Step Three:* aggregate lifetime taxable gifts (sum of steps one and two) = \$900,000.

*Step Four:* tentative tax on aggregate lifetime gifts = \$306,800.

*Step Five:* tax on prior years' taxable gifts (\$600,000 from step two) = \$192,800.

*Step Six:* tax on current year's taxable gifts (tax in step four less tax in step five) = \$306,800 - 192,800 = \$114,000. This is the amount of tax before application of any credits (see below).

*Net Gift Tax Liabilities—Application of Unified Credit*

I.R.C. § 2505 provides for a lifetime unified credit in the amount of \$192,800 to offset gift (and effectively, estate) tax liabilities. Application of the unified credit to our example would result in the following net gift tax liabilities:

*1993 Net Gift Tax Liability*

A "taxable gift" is generally the value of property transferred by gift<sup>32</sup> less certain exclusions<sup>33</sup> and deductions.<sup>34</sup> Nevertheless, to thor-

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Gift Tax before credit (from above)	\$ 87,800
Available credit	(192,800)
Net Gift Tax Liability	None
Unified Credit remaining	\$105,000
<i>1994 Net Gift Tax Liability</i>	
Gift Tax before credit (from above)	\$105,000
Available credit	(105,000)
Net Gift Tax Liability	None
Unified Credit remaining	None
<i>1995 Net Gift Tax Liability</i>	
Gift Tax before credit (from above)	\$114,000
Available credit	None
Net Gift Tax Liability	\$114,000
Unified Credit remaining	None

*Id.*

32. I.R.C. § 2512 (1988). "If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift." *Id.* The value of the property is the price at which a knowledgeable, willing buyer and a willing seller, neither being under any compulsion to buy or sell, would agree. Treas. Reg. § 25.2512-1 (as amended in 1992). If the property transferred is in the form of stocks and bonds, the value of such property is the fair market value per share or bond on the date of the gift. *Id.* § 25.2512-2. The value of a secured or unsecured note is generally deemed to be the amount of unpaid principal, plus any accrued interest up to the date of the gift. *Id.* § 25.2512-4. The value of a business is the amount that a willing buyer and a willing seller would agree upon considering all of the relevant factors. *Id.* § 25.2512-3. The relevant factors include a fair appraisal of all the business assets including good will and the earning capacity of the business. *Id.* Determining the value of transferred property often can be difficult. See generally Mitchell M. Gans, *Gift Tax: Valuation Difficulties and Gift Completion*, 58 NOTRE DAME L. REV. 493, 493 (1983) (examining the valuation-difficulty rule as applied to gifts not immediately capable of valuation).

33. I.R.C. § 2503 (1988). Before determining the amount of taxable gifts, certain exclusions must be subtracted from the total amount of the taxpayer's annual transfers. First, certain medical or tuition expenses paid for the benefit of another are excluded from taxable gifts. *Id.* § 2503(e); see *infra* notes 147-155 and accompanying text. Each taxpayer is also entitled to a yearly \$10,000 exclusion for each gift recipient. I.R.C. § 2503(b). Thus, if Bob has three children and gives each of them \$10,000 outright per year, he has made no taxable gifts. However, to qualify for the annual exclusion, the donee must have the right to immediate use, possession, or enjoyment of the property. Gifts of future interest, such as reversions and remainders, do not qualify for the annual exclusion. Treas. Reg. § 25.2503-3(a) (as amended in 1983). To illustrate, Bob puts \$10,000 per child into a trust each year instead of making outright gifts, and the trust calls for accumulation of trust income and nondistribution of trust corpus until sometime in the future. Because the children's right to receive such income is subject to delay, it is not a present interest and Bob is not entitled to any annual exclusions. Treas. Reg. § 25.2503-3, Ex. 1 (as amended in 1983). Finally, if the donee makes a qualified disclaimer of the gift, it is excluded from taxable gifts. I.R.C. § 2518 (1988).

34. In addition to exclusions from taxable gifts, the taxpayer is entitled to certain deductions. Any gift to a qualified charity is generally entitled to a gift tax deduction for the entire amount of the transfer. I.R.C. § 2522 (1988); see *infra* note 143. Additionally, gifts made between spouses are deducted in full and not subject to gift tax. I.R.C. § 2523 (1988 & Supp. V 1993).

oughly comprehend the tortuous quandary of applying the gift tax, two issues must be addressed: (1) What constitutes "property"?; and (2) When is a "transfer" considered a "gift"? The latter is addressed first.

### B. What Is a "Gift" for Gift Tax Purposes?

The common-law definition of a gift is "a voluntary transfer of property to another made gratuitously and without consideration."<sup>35</sup> The determination of a gift for *income tax purposes* (to ascertain if such a gift is excluded from the recipient's taxable income<sup>36</sup>) looks to the intent of the donor—that is, did the transfer proceed from a "detached and disinterested generosity"?<sup>37</sup> Unfortunately, the common-law definition of a gift is woefully inadequate and income tax rules are, for the most part, irrelevant in the determination of a gift for gift tax purposes.<sup>38</sup>

Pursuant to Internal Revenue Code (I.R.C.) § 2501, the duty to pay the gift tax attaches upon the "transfer of property by gift."<sup>39</sup> According to the Treasury regulations, "any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax."<sup>40</sup> While intent to make a gift is clearly required,<sup>41</sup> such intent need not be "gratuitous" in the literal sense. Indeed, a gift for gift tax purposes could be wholly lacking in the qualitative sentiment that one

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35. BLACK'S LAW DICTIONARY 688 (6th ed. 1990).

36. I.R.C. § 102(a) (1988) states that "[g]ross income does not include the value of property acquired by gift, bequest, devise, or inheritance." Generally transfers from employers to employees are not considered "gifts" for purposes of this section. *Id.* § 102(c).

37. Commissioner v. Duberstein, 363 U.S. 278, 285 (1960) (quoting Commissioner v. LoBue, 351 U.S. 243, 246 (1956)). Similarly, *Black's Law Dictionary* defines a gift for income tax purposes as a transfer made "without conditions, from detached and disinterested generosity, out of affection, respect, charity or like impulses, and not from the constraining force of any moral or legal duty or from the incentive of anticipated benefits of an economic nature." BLACK'S LAW DICTIONARY 688 (6th ed. 1990).

38. Inconsistency exists between the estate and gift tax, on the one hand, and the income tax, on the other hand. For example, a property transfer may be sufficiently final to subject the donor to a gift tax, yet it may not be complete enough to terminate the donor's income tax liability. See, e.g., *Lockard v. Commissioner*, 166 F.2d 409, 411 (1st Cir. 1948) (holding that transfers in trust constituted taxable gifts and that the amounts of specific exemption must be deducted from the specific exemption claimed in the tax return). Similarly, a transfer may not shift the income tax liability to the donee, and yet the transfer is not considered a gift for gift tax purposes. BITTKER & CLARK, *supra* note 3, at 13.

39. I.R.C. § 2501(a)(1) (1988).

40. Treas. Reg. § 25.2511-1(c)(1) (as amended in 1994).

41. See, e.g., *Commissioner v. Hogle*, 165 F.2d 352, 353 (10th Cir. 1947) (finding that Congress intended the gift tax to apply "to all transactions whereby property or property rights or interests are *donatively* passed or conferred upon another" (emphasis added)).

might envision accompanies the act of making a gift.<sup>42</sup> Instead, the Treasury Department focuses on the "objective facts of the transfer and the circumstances under which it is made, rather than on the subjective motives of the donor" when determining whether a taxable gift has been made.<sup>43</sup> The objective determination of a transfer by gift for gift tax purposes is explained in the Treasury regulations as follows:

Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts, but embrace as well sales, exchanges, and other dispositions of property for a consideration to the extent that the value of the property transferred by the donor exceeds the value in *money or money's worth* of the consideration given therefor.<sup>44</sup>

Put in simple terms, a gift is made by transferring property without receiving consideration of a comparable value in money or money's worth in return. The Supreme Court has made it clear that not all common-law forms of consideration are reducible to the requisite money or money's worth standard.<sup>45</sup> Most notable are the types of consideration or promises that every first-year law student learns

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42. See, e.g., *Commissioner v. Wemyss*, 324 U.S. 303 (1945). In *Wemyss*, the taxpayer was receiving income from her deceased husband's trust, but if she were to remarry, the income payments would cease. *Id.* at 303-04. To induce the taxpayer to remarry, her new husband agreed to transfer some stock to the taxpayer in exchange for her wedding vows. *Id.* at 304. The taxpayer contended that the stock transfer did not constitute a taxable gift because her agreement to remarry provided adequate consideration for the stock. *Id.* at 304-05. The Court did not agree. Consideration not reducible to money value, such as an agreement to marry, is "wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift." *Id.* at 305 (quoting *Treas. Reg.* 79 (1936 ed.) Art. 8). In coming to this conclusion, the Court found that Congress "dispensed with the test of 'donative intent' when determining taxable gifts and "chose not to require an ascertainment of what too often is an elusive state of mind." *Id.* at 306. The Treasury regulations have also adopted this position by stating that "[d]onative intent on the part of the transferor is not an essential element in the application of the gift tax to the transfer." *Treas. Reg.* § 25.2511-1(g)(1) (as amended in 1994). Note that if the *Wemyss* fact pattern had been applied in the income tax forum, no gift would have been found because the transfer was made for a promise to marry rather than out of "detached and disinterested generosity." *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960) (quoting *Commissioner v. LoBue*, 351 U.S. 243, 246 (1956)); see also *supra* notes 35-38 and accompanying text.

43. *Treas. Reg.* § 25.2511-1(g)(1) (as amended in 1994).

44. *Id.* § 25.2512-8 (as amended in 1992) (emphasis added).

45. *Wemyss*, 324 U.S. 303; see also *supra* note 42. The Treasury regulations state this principle as follows: "A consideration not reducible to a value in money or money's worth, as love and affection, promise of marriage, etc., is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift." *Treas. Reg.* § 25.2512-8 (as amended in 1992).

are entirely sufficient for the basis of an enforceable contract, such as a promise to stop smoking and drinking for a year, or a promise to marry.<sup>46</sup> Because such consideration cannot be valued in terms of money or money's worth, it is totally disregarded in the determination of whether a gift has been made for gift tax purposes.<sup>47</sup>

This brings us to the focus of this Article: transfers of property made for another's support or maintenance. A father sends money to his child for college education expenses, including tuition, room, and board. A daughter pays the living expenses for her ailing mother. To determine the gift tax liability of these transfers, several questions must be answered: Did the father directly or indirectly receive adequate consideration from his child in money or money's worth? Did the daughter receive sufficient consideration in money or money's worth? The layman would probably find such an inquiry to be absurd, and rightly so. These transfers are not the variety that spring to mind when gift taxes are contemplated. Indeed, taxing these transfers is not consistent with the rationale behind the federal gift tax. As discussed previously, the gift tax was implemented to prevent the tax-free diminution of an individual's estate through inter vivos transfers.<sup>48</sup> Clearly the above transfers are not motivated by an individual's legal obligation nor a desire to avoid estate taxes. Rather, they originate from an individual's moral conscience. Nevertheless, the fact that such transfers may not have been made in exchange for consideration in money or money's worth might expose the transferor to a gift tax.

When making transfers for the support of another, the determination of whether the requisite consideration has been received by the transferor (resulting in no taxable gift) is based upon the transferor's legal support obligations. Generally, when a transfer is made in discharge of an individual's legal support obligation there is no gift.<sup>49</sup> However, transfers of support that are inspired solely by moral conscience may very well be subject to a gift tax.<sup>50</sup> This opprobrious

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46. See, e.g., *Hamer v. Sidway*, 124 N.Y. 538, 550-51 (1891) (holding that a nephew who refrained from drinking, using tobacco, and gambling until he turned 21 had provided adequate consideration to create a valid contract); *Shadwell v. Shadwell*, 142 Eng. Rep. 62, 64 (1860) (finding that a promise to marry constitutes adequate consideration to form a contract).

47. Treas. Reg. § 25.2512-8 (as amended in 1992).

48. See *supra* notes 24-27 and accompanying text. The Supreme Court recognized that the "legislative history of the gift tax provisions reflects that Congress enacted a tax on gifts to supplement existing estate and income tax laws." *Dickman v. Commissioner*, 465 U.S. 330, 338 (1984).

49. See *infra* notes 73-76 and accompanying text.

50. See *infra* notes 77-79 and accompanying text.

result flies in the face of the public policy of caring and providing for one another.

### C. *What Is Property?*

As indicated above, I.R.C. § 2501 imposes the gift tax on the "transfer of *property* by gift."<sup>51</sup> For example, when an individual gratuitously transfers money, jewelry, real estate, or shares of stock to a friend, little doubt arises that these items are property. Therefore, assuming that no requisite consideration in money or money's worth was received, a gift has been made.<sup>52</sup> However, the term "property," as used for gift tax purposes, is much more encompassing than these obvious transfers of tangible assets. It is clear from both legislative history and court cases that the term property is not to be narrowly construed. Quite to the contrary, "Congress intended to use the term 'gifts' in its broadest and most comprehensive sense,"<sup>53</sup> including "every species of right or interest protected by law and having an exchangeable value."<sup>54</sup>

The scope of the term "property," as it applies to transfers by gift, was tested in *Dickman v. Commissioner*.<sup>55</sup> In *Dickman*, parents loaned substantial sums of money to their son and to a corporation owned by the family.<sup>56</sup> These loans "were evidenced by demand notes bearing no interest."<sup>57</sup> The commissioner did not seek to impose the gift tax on the principal of the loan because it had to be repaid.<sup>58</sup> Rather, the Court said that a gift had been made with respect to the value of the *use* of the money because there was no obligation for the son to pay back any interest.<sup>59</sup> The Court rationalized that when the parents transferred the *use* of the money, an identifiable property interest clearly changed hands. This interest had an easily measurable value that could be associated with the *use* of the property transferred: the amount of interest that should have been charged but was not.<sup>60</sup> In

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51. I.R.C. § 2501(a)(1) (1988) (emphasis added).

52. Note that the gift tax applies "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible." *Id.* § 2511(a).

53. *Commissioner v. Wemyss*, 324 U.S. 303, 306 (1945) (quoting H.R. REP. NO. 708, 72d Cong., 1st Sess. 27 (1932); S. REP. NO. 665, 72d Cong., 1st Sess. 39 (1932)).

54. *Dickman v. Commissioner*, 465 U.S. 330, 334 (1984) (quoting H.R. REP. NO. 708, 72d Cong., 1st Sess. 27 (1932); S. REP. NO. 665, 72d Cong., 1st Sess. 39 (1932)).

55. *Id.* at 330.

56. *Id.* at 332.

57. *Id.*

58. *Id.*

59. *Id.* at 335-36.

60. *Id.* at 336-37.

effect, the lenders/parents were deemed to have charged a fair rate of interest, the borrower/son was deemed to have paid this interest to the lenders/parents, and the lenders/parents were then deemed to have gratuitously transferred this interest back to the borrower/son.<sup>61</sup> Therein lies the gift.

Unfortunately, the Court did not specifically limit its holding in *Dickman* to situations involving interest-free demand loans. As argued by the taxpayer in *Dickman*, a holding such as the Court's could have the potential to create taxable gifts for any use of property including a son's use of his parents' car, a grandparent's use of a bedroom in a relative's home, and a neighbor's use of "a loan of the proverbial cup of sugar."<sup>62</sup> With a somewhat cavalier attitude, the majority addressed the possible severe consequences of its holding by assuming that "the focus of the Internal Revenue Service is not on such traditional familial matters."<sup>63</sup>

When an adult daughter merely borrows her father's car to run an errand, there is no rational argument that the use of the car should subject this trivial transfer to a gift tax. Likewise, when an adult son

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61. *Id.* at 335-36 n.5.

62. *Id.* at 340. See generally Mark J. Wolff, *Dickman Confined: The Taxation of Gratuitous Transfers of Use*, 21 STETSON L. REV. 509 (1992) (analyzing a restricted view of *Dickman v. Commissioner* in the context of the case's ancestry and progeny).

63. *Dickman*, 465 U.S. at 341. Now that more than 10 years have passed since *Dickman*, it is arguable that the IRS has not acted as reasonably as the Court assumed it would in limiting the *Dickman* holding. For instance, the *Dickman* rationale has been extended in the area of asset freezes. Priv. Ltr. Rul. 87-23-007 (Feb. 18, 1987). The IRS has extended *Dickman* on numerous occasions to grantor-retained income trusts (GRITs). Priv. Ltr. Rul. 88-01-008 (Oct. 7, 1987); Priv. Ltr. Rul. 88-05-029 (Nov. 9, 1987); Priv. Ltr. Rul. 88-06-082 (Nov. 18, 1987); Priv. Ltr. Rul. 88-15-005 (Jan. 7, 1988); Priv. Ltr. Rul. 88-23-029 (June 10, 1988); Priv. Ltr. Rul. 88-23-030 (June 10, 1988); Priv. Ltr. Rul. 88-44-008 (Nov. 4, 1988); Priv. Ltr. Rul. 90-52-011 (Dec. 28, 1990); Priv. Ltr. Rul. 90-52-031 (Dec. 28, 1990); Priv. Ltr. Rul. 91-09-027 (Mar. 1, 1991). In these cases, the IRS has stated that trusts funded with unproductive or under-productive assets constitute both complete and partially incomplete gifts. The rationale is that a grantor-income beneficiary, by not exercising his rights to require the trustee to invest in productive assets, makes an annual transfer to the remainderman.

Additionally, the IRS has found that a parent who guarantees loans of a corporation of which his children are shareholders has made a taxable gift. Priv. Ltr. Rul. 91-13-009 (Mar. 29, 1991). The IRS justified this position by noting that a guarantee of payment is a valuable economic benefit. Without the guarantee, the children may not have been able to get a loan at all, or would have had to pay higher interest rates. *Id.* Even though the father could call on the children for reimbursement in the event he was asked to make good on the guarantee, the IRS deemed the transfer to be lacking in adequate consideration. *Id.* See generally Valerie C. Robbins, *Parent's Guarantee of Loan Results in a Gift*, 22 TAX ADVISER 514 (1991) (discussing the extension of the *Dickman* rationale in treating certain indirect transfers as gifts). Most recently, the IRS extended *Dickman* to a son's failure to exercise his first right of refusal in the context of a buy-sell agreement with the father. Priv. Ltr. Rul. 91-17-035 (Apr. 26, 1991).

pays a visit to his parents and sleeps in his old room, it hardly seems reasonable that a taxable gift has occurred. Of course, while the *Dickman* rationale could technically be applied to these familial situations, it would be a farcical application of the gift tax.

Is it, however, inappropriate to apply such "use of property" logic to *all* familial situations? Suppose Mom and Dad own a small cottage on the beach in Malibu, California, which for years has been rented out to unrelated individuals. Beachfront property in Malibu commands astronomical rents and the cottage, while very small, rents for \$8000 per month. Their adult son, unfortunately beset with personal problems, is unemployed and financially troubled. Though not legally obligated, the concerned and conscientious parents allow their son to live in the cottage without remuneration.

Is this still a familial *use* of property without gift tax implication? Or, has it been transformed into a taxable situation, where a valuable property interest has been transferred—the measure of this interest equal to the \$8000 per month rent the parents have admirably foregone? Would the analysis change if the parents had not previously rented out the cottage but, rather, had used it only for vacations? According to the Court in *Dickman*, it was irrelevant whether or not the property transferred for use by another was otherwise invested and earned a return.<sup>64</sup> The Court's criteria for determining a taxable gift were deemed to be fulfilled by the individual's conscious decision to transfer a valuable property right—the gift then measured by the fair value of the property's use.<sup>65</sup>

Enter the questions that permeate the gift tax debacle: Is there a gift once the parents make the conscious decision to allow their son to live in the cottage rent-free (regardless of the cottage's past rental activity)? Or, is the use of the property a nontaxable familial transaction that is excluded (or, more accurately, not to be pursued by the IRS) by the vague and undefined dicta of *Dickman*?<sup>66</sup> No unqualified argument can be made that at a fair rental value of \$8000 per month, or

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64. *Dickman*, 465 U.S. at 340. In *Dickman*, the taxpayer asserted that the interest-free loan should not be taxed based on the possibility that the money lent could instead have been invested and produced income. *Id.* at 339-40. The Court, however, rejected this rationale. It is true that "[a]n individual may, without incurring the gift tax, squander money, conceal it under a mattress, or otherwise waste its use value by failing to invest it." *Id.* at 340. Nevertheless, if the taxpayer decides to transfer the use of the money to another rather than wasting it, the transfer is subject to the gift tax. *Id.* "That the transferor himself could have consumed or wasted the use value of the money without incurring the gift tax does not change this result." *Id.*

65. *Id.* at 344. The Court determined the amount of the gift to be "the reasonable value of the use of the money lent." *Id.*

66. See *supra* note 63 and accompanying text.



\$96,000 per year, a valuable property right has not been transferred. Furthermore, if the two beach cottage scenarios above are indistinguishable for gift tax purposes, what then of the adult child being allowed to live rent-free in a bedroom of the parent's house? When viewed in isolation, this situation scarcely seems appropriate for an application of the gift tax. However, in light of *Dickman*, what specific factor circumscribes such conceivable events as nontaxable familial situations?

The problematic effect of all this indefiniteness is that there is no bright line test to determine what constitutes a transfer of property that is a gift for gift tax purposes. While it is clear that Congress intended the gift tax to reach those transactions made in an attempt to avoid estate tax,<sup>67</sup> exactly when a nontaxable familial transaction metamorphoses into a taxable gift is not as clear. As will be discussed in the next section, support transfers (transfers made for the support of another) are often plagued by uncertainty, inconformity, and non-uniformity of gift tax application.

## II. SUPPORT TRANSFERS AND THE GIFT TAX

The motivation behind most transfers for support stems not from a desire to avoid the estate tax, but from an individual's sense of humanity and decency. It is unlikely that Congress intended to tax those transfers wherein the donor is merely giving the financial support that is typically provided in a normal familial relationship.<sup>68</sup> Even so, without adequate consideration, support transfers are taxable gifts regardless of the donor's selfless intention.<sup>69</sup> As previously discussed, a transfer of property will be considered a gift for gift tax purposes if, and to the extent, the transferor does not receive adequate consideration in money or money's worth.<sup>70</sup> Consideration such as love and affection, while constituting legal consideration for contract purposes, is totally disregarded in defining consideration for gift tax purposes.<sup>71</sup> Given this criteria for determining valid consideration, the next step in this journey through the gift tax labyrinth is to distinguish

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67. *Dickman*, 465 U.S. at 338.

68. Note, *Federal Tax Aspects of the Obligation to Support*, 74 HARV. L. REV. 1191, 1213 (1961).

69. See *supra* notes 39-47 and accompanying text.

70. I.R.C. § 2512(b) (1988); see *supra* notes 44-47 and accompanying text.

71. Treas. Reg. § 25-2512-8 (as amended in 1992). The regulation states that "[a] consideration not reducible to a value in money or money's worth, as love and affection, promise of marriage, etc., is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift." *Id.*

between nontaxable and taxable support transfers under the current Internal Revenue Code.

A. *Legal Versus Moral Obligation to Support—Nontaxable Versus Taxable Gifts*

Every state, either by statute or common law, imposes some obligation to support certain individuals.<sup>72</sup> Typical relationships that impose some duty of support are parent and child (most commonly a parent's duty to support minor children and, much less frequently, a parent's duty to support an adult child or a child's duty to support a parent), and husband and wife.<sup>73</sup>

It is generally understood that a discharge of one's legal obligation to support constitutes, for gift tax purposes, valid consideration in money or money's worth.<sup>74</sup> Discharging one's obligation usually involves the providing, in kind, of those items that constitute support. Therefore, a parent providing shelter, food, and clothing for a minor child (whom the parent has a legal duty to support) will be making support transfers that are nontaxable under the federal gift tax. In addition to in-kind support, payments such as divorce-related child support can constitute the discharge of one's legal obligations, thereby resulting in non-gift-tax transfers.<sup>75</sup> However, the existence of a legal obligation for support does not always rule out the implication of gift tax. Taxable gifts may result when the value of property transferred exceeds the value of the donee's right to support.<sup>76</sup>

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72. See *infra* notes 81-89 and accompanying text.

73. See *infra* notes 81-89 and accompanying text.

74. Note, *Valuation of the Right to Support for Purposes of the Federal Tax System*, 72 COLUM. L. REV. 132, 135 (1972). Interestingly, a proposed regulation, which was never adopted, clearly stated that the discharge of a legal support obligation was not a taxable gift. Prop. Treas. Reg. § 25.2511-1(f)(1), 22 Fed. Reg. 2 (1957). Nonetheless, because a monetary value can be placed on a legally imposed support obligation, its discharge should constitute consideration in money or money's worth. Krahmer, *Gifts*, 154-4th Tax Mgmt. (BNA), at A-7 (1988). Commentators generally agree that

[t]his is one of the many areas in which estate and gift tax problems are analogous and, even if the estate tax statute is more precise, like results should be reached under both taxes. Thus, under § 2053, a decedent's obligations are deductible; but if found on a promise, they are not, unless incurred for full consideration in money or money's worth. Obligations imposed by law, however, are deductible without regard to consideration. By analogy, lifetime transfers that discharge obligations imposed by law are not subject to gift tax.

RICHARD B. STEPHENS ET AL., *FEDERAL ESTATE AND GIFT TAXATION* ¶ 10.02[5], at 10-51 n.84 (6th ed. 1991).

75. For divorce-related discharge of support obligations, see *infra* notes 97-105 and accompanying text.

76. See *infra* notes 90-94 and accompanying text.

The counterpart to the nontaxable transfers in discharge of a legal support obligation, are transfers for another's support arising solely out of a moral obligation, which are generally taxable. An example of such a situation is that of a parent supporting an adult child, which is common in practice but rarely an obligation pursuant to state law.<sup>77</sup> Although it seems that a mother's support of her handicapped adult child should never result in gift tax liability, the fact of the matter is that unless that mother has a *legal* duty to support the adult child,<sup>78</sup> a taxable gift may transpire.<sup>79</sup>

The key, therefore, to the application of a gift tax in support issues is found in the answers to the following questions: when does an individual have a legal (state-imposed) obligation to support; what is the extent of such an obligation; and what are the tax ramifications when the support that is provided exceeds the state-imposed legal obligation?

*B. When One Has a Legal Obligation to Support Another—General Determination Under State Law*

It is common knowledge, or more appropriately common behavior, that parents provide support for their minor children. While paying exorbitant sums to buy the latest athletic shoes, only to have the child's feet outgrow them long before the end of their useful life, may not be a pleasant thought, it is typically accepted as part of one's parental duties. This, along with providing food, shelter, transportation, education, and the like, makes up the customary financial burden of supporting a child. If such support is being furnished pursuant to a state-imposed obligation (a legal obligation), these types of transfers

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77. See *infra* notes 83-87 and accompanying text.

78. Of course, in some instances a state may impose a continuing duty of support with respect to a handicapped child regardless of age. See *infra* notes 83-87 and accompanying text.

79. While not plentiful, perhaps because of the lack of asking, there are incidences in which the IRS has held that transfers by parents for the support of their adult handicapped child are subject to gift tax (where there is no accompanying legal duty to support). See Tech. Adv. Mem. 81-35-032 (Apr. 28, 1981) (finding that payments made during the decedent's life to her adult handicapped children constituted taxable gifts); Gen. Couns. Mem. 38,702 (Apr. 28, 1981) (concurring with Tech. Adv. Mem. 81-35-032); see also *Fisher v. United States*, 28 Cl. Ct. 88 (1993) (holding that because there is no legal duty to support after emancipation under Washington law, transfers made from father to his adult handicapped son were subject to gift tax).

are not in question as they are deemed to be for adequate and full consideration, thus obviating a gift tax.<sup>80</sup>

Consistent with what is considered normal behavior, every state imposes a duty upon parents to support a minor child. This universally recognized obligation is imposed either by common law or statute.<sup>81</sup> Food, shelter, clothing, medical attention, education, and the like, are the core components of support.<sup>82</sup>

When a child reaches the age of majority, a parent's legal obligation for support generally ceases.<sup>83</sup> Continued support for an adult child, though arguably justifiable as a parental or moral duty, is generally not accompanied by a legal obligation. Absent a legal obligation to act as consideration in money or money's worth, such support constitutes a gift for gift tax purposes.<sup>84</sup>

Nonetheless, not every support issue involving an adult child lacks the requisite legal obligation. The parental duty of support may exist when a child is incapacitated or otherwise unable to care for himself after reaching adulthood.<sup>85</sup> Unfortunately, the imposition and extent of such support obligations are not uniform among the states.<sup>86</sup> As state law is determinative of whether a legal obligation for support exists, and this legal obligation is in turn determinative of a

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80. "[A] transfer to one that the transferor has a legal obligation to support is for adequate and full consideration and thus is not a taxable gift to the extent that the transfer provides reasonable support." Gen. Couns. Mem. 38,702 (Apr. 28, 1981).

81. An in-depth discussion of state-imposed support obligations is beyond the scope of this Article. For a general discussion of state-imposed support obligations, see 59 AM. JUR. 2D *Parent and Child* §§ 41-74 (1987).

82. For the extent of support and corresponding gift tax ramifications, see *infra* notes 90-95 and accompanying text.

83. For a general discussion, see Annotation, *Parent's Obligation to Support Adult Child*, 1 A.L.R.2D 910, 912-14 (1993); see also 59 AM. JUR. 2D *Parent and Child* §§ 88, 89 (1987).

84. See *supra* notes 77-79 and accompanying text.

85. See Annotation, *supra* note 83, at 920, 935-39; see also Noralyn O. Harlow, Annotation, *Postmajority Disability as Reviving Parental Duty to Support Child*, 48 A.L.R.4TH 919 (1993) (noting that some states impose a support obligation only if child is disabled upon reaching majority but not if child becomes disabled subsequent to reaching majority); 59 AM. JUR. 2D *Parent and Child* § 90 (1987). For a Treasury determination on this issue, see Priv. Ltr. Rul. 77-280-03 (Mar. 31, 1977) (finding that under Maryland law, "parents are liable for the support of incompetent adult children, as well as for the support of minor children").

86. See Annotation, *supra* note 83, at 920, 934-39; 59 AM. JUR. 2D *Parent and Child* § 90 (1987). See generally Lee E. Teitelbaum, *Intergenerational Responsibility and Family Obligation: On Sharing*, 1992 UTAH L. REV. 765, 789-91 (discussing differing support obligations among the states); Harlow, *supra* note 85, at 934-44 (noting cases); David Beck & Sheldon V. Ekman, *Where Does Support End and Taxable Gift Begin?*, 23 N.Y.U. INST. ON FED. TAX'N 1181, 1184 (1965) (discussing the differing state standards for parental support of children).

gift for gift tax purposes, there is, in effect, an inconsistent application of federal gift tax laws among the states.<sup>87</sup>

Similar to a parent's support of an adult child, it is universally accepted that there is no general legal obligation for a child to support a parent. Only in certain jurisdictions and in very limited situations (for example, in the case of certain "indigent" parents) is there a state-imposed duty to support a parent.<sup>88</sup> Adding to the uncertainty of the law, a few states may require the support of certain relatives outside the immediate family.<sup>89</sup> The result of this inconformity in the law is disconcerting. A caring son in one state may be insulated from federal gift taxes because the support provided to an aging mother is mandated by state statute, while support for a parent by an equally caring daughter in another state represents a taxable gift because there is no legal duty of support.

### C. *Extent of Support Obligation*

Thus far, we have seen that the satisfaction of a legal duty to support is deemed adequate consideration in money or money's worth so

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87. Confusion about the role a state's notion of legal obligation plays in determining federal gift tax is illustrated by *Commissioner v. Greene*, 119 F.2d 383 (9th Cir.), *cert. denied*, 314 U.S. 641 (1941). The *Greene* court addressed the issue of whether support payments made pursuant to state law constitute taxable gifts, reasoning that "[t]he only thing in question here is the 'consideration.' Nothing in the act expressly states that the existence of consideration is to be determined by state law." *Id.* at 385. Thus, the court found that the taxpayer had made a taxable gift despite the taxpayer's legal obligation to support under state law. *Id.*

The *Greene* decision, however, has been criticized and generally is not thought to be a valid interpretation of support-based consideration for gift tax purposes. See STEPHENS ET AL., *supra* note 74, at 10-52. For example, the IRS consistently determines valid consideration in discharge of legal support obligations based upon state laws. See, e.g., Priv. Ltr. Rul. 81-35-032 (June 1, 1981) ("The existence of a legally enforceable obligation to support must be determined with reference to local law."); see also Rev. Rul. 73-612, 1973-2 C.B. 322 (discussing "[p]ayments from incapacitated ward's estate under Florida law").

88. For good discussion of the issue, see Ann Britton, *America's Best Kept Secret: An Adult Child's Duty to Support Aged Parents*, 26 CAL. W. L. REV. 351 (1989-90). See also 59 AM. JUR. 2D *Parent and Child* § 91 (1987); Note, *supra* note 68, at 1193. The California Civil Code provides that it is the duty of "the children of any person in need who is unable to maintain himself by work, to maintain such person to the extent of their ability." CAL. CIV. CODE § 206 (West 1982). Both the California court and the Treasury Department have disregarded *Greene* and applied the plain meaning of the law. See, e.g., *Swoap v. Superior Court*, 516 P.2d 840, 848 (Cal. 1973) (finding that "[i]t is abundantly clear that children have generally been subject to a duty to support poor parents for a very long time, indeed"); Priv. Ltr. Rul. 82-25-091 (Mar. 25, 1982) (stating that "to the extent that current income of the trust is applied in satisfaction of the donor's legal obligation to support or maintain his parents there is no gift").

89. Note, *supra* note 68, at 1193. For an examination of intrafamily support responsibilities, see Teitelbaum, *supra* note 86, *passim*.

as to not constitute a gift subject to gift tax. Providing transportation for one's minor child clearly fits within the auspices of such support. What of the parent who, on the occasion of a daughter's sixteenth birthday, presents her with a Ferrari automobile wrapped with a big bow? This is, of course, transportation and the parent's state-determined obligation to support a minor child does encompass the duty to provide transportation. If it is the support obligation under state law that determines the existence of consideration, then it follows that property transferred must be analyzed in relation to the extent of such obligation to support. Discharge of a support obligation shall be deemed adequate consideration only to the extent that the law requires such obligation. Support provided in excess of what is required under state law (even though required to some degree with respect to a particular individual) is not in exchange for consideration in money or money's worth. Therefore, it is a gift for gift tax purposes.<sup>90</sup>

If one has a state-determined obligation of support for another, is there a particular level of support that one is typically required to provide? The most general definition of the duty to support requires the furnishing of such support that is "determined . . . by the means, ability, social position and circumstances both of the particular [obligor] and his [obligee]."<sup>91</sup> Such support is usually limited to providing the necessities of life to the recipient.<sup>92</sup> Necessaries obviously exclude extravagant purchases or luxuries above and beyond a person's normal living needs.<sup>93</sup> Yet once again no exact standard exists to gauge the scope of these necessities, and, as a result, court decisions lack uniformity in this area.<sup>94</sup>

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90. See generally Beck & Ekman, *supra* note 86, at 1188-1202 (discussing obligations to support pursuant to gift tax law).

91. State v. Moran, 121 A. 277, 279 (Conn. 1923). California courts have found that a "[p]arent's support obligation does not end when furnishing mere necessities, for the minor is entitled to be maintained in a style and condition consonant with his parents' financial ability and position in society." *In re Ricky H.*, 468 P.2d 204, 208 (1970); see also *Entrekin v. Entrekin*, 627 So. 2d 955, 956 (1993) (interpreting Alabama law to include postminority support based upon the reasonable necessities of the child's college expenses); *Kennedy v. Sniffen*, 23 Haw. 115, 118 (1916) (requiring reimbursement of necessities based on the child's "station in life").

92. Beck & Ekman, *supra* note 86, at 1185.

93. *Bergh v. Warner*, 50 N.W. 77, 78 (Minn. 1891) (holding that diamond earrings are outside the scope of "necessaries" when determining the extent of the support obligation). Some specific examples of necessities include food and lodging, but not room and board at a beach hotel for the summer. *Stevens v. Hush*, 176 N.Y.S. 602, 605 (N.Y. App. Term 1919). Also, clothing and medical expenses are obviously deemed necessities. *Moran*, 121 A. at 279. In terms of the obligation of support under state law, the standard as to the extent of support required is usually phrased as "station of life" or "standard of living." *Id.*

94. Beck & Ekman, *supra* note 86, at 1186.

If decisions lack uniformity in this area, then so does the possible application of the federal gift tax. This is the paradox of the supposedly equal and uniform federal tax law that Congress has yet to address. For even if the determination of a taxable transfer is to remain as vague as the approach used in *Dickman v. Commissioner*,<sup>95</sup> the same ill-defined determination should be equally applied throughout the states.

#### *D. Support in Connection with a Marriage Dissolution*

In the context of a marriage dissolution, spousal and child support are transfers that can generate gift tax questions. Historically, the gift tax status of divorce-related support transfers, at least with respect to spousal support, was shrouded in confusion. In some instances, such transfers were considered made for adequate consideration in money or money's worth, while in other situations that were hardly distinguishable, gift tax resulted.<sup>96</sup> In order to provide some relief for divorcing couples, at least two exceptions have been carved out in which transfers of property are treated as if they occurred with adequate consideration.<sup>97</sup>

The statutory exception is found at I.R.C. § 2516. This section provides an exemption from the gift tax for transfers of property, pursuant to a written instrument, within three years of divorce beginning one year before such an agreement was entered into.<sup>98</sup> If these requirements are met, the transaction is deemed to have been made

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95. 450 U.S. 330 (1984); see *supra* notes 55-67 and accompanying text.

96. Compare E.T. 19, 1946-2 C.B. 166 (finding that transfers incident to separation agreement in exchange for support rights were made for adequate consideration, but gifts resulted to the extent transfers were in exchange for release of dower, curtesy, or other such rights) and *Merrill v. Fahs*, 324 U.S. 308 (1945) (holding that a transfer of property in exchange for a release of dower and curtesy rights—but not support rights—pursuant to antenuptial agreement was considered a gift) with *Mitchell v. Commissioner*, 6 T.C. 159 (1946) (holding that transfers pursuant to a separation agreement in exchange for dower/curtesy or support rights were not gifts).

97. See generally Schlissel & Skarlatos, *supra* note 27, at 81-92.

98. I.R.C. § 2516 (1988). This section creates a statutory exception from gift tax as follows:

Where husband and wife enter into a written agreement relative to their marital and property rights and divorce occurs within the 3-year period beginning on the date 1 year before such agreement is entered into (whether or not such agreement is approved by the divorce decree), any transfers of property or interests in property made pursuant to such agreement -

- (1) to either spouse in settlement of his or her marital or property rights, or
- (2) to provide a reasonable allowance for the support of issue of the marriage during minority, shall be deemed to be transfers made for a full and adequate consideration in money or money's worth.

*Id.*

"for full and adequate consideration," and no gift tax liability results.<sup>99</sup> The scope of this section covers transfers to the other spouse in settlement of his or her property rights,<sup>100</sup> and a reasonable allowance for the support of any children of the marriage *during their minority*.<sup>101</sup> This statutory provision adds little, however, with respect to gift taxation of child support payments because of its application only to minor children, for whom such support is free from gift tax even in absence of this section.

The second scenario in which a transfer is deemed to have adequate consideration in divorce transactions was carved out in *Harris v. Commissioner*.<sup>102</sup> In *Harris*, the Court held that, in certain circumstances, property transfers pursuant to a divorce-related separation agreement do not constitute taxable gifts. The promise in the separation agreement did not itself constitute valid consideration for gift tax purposes, the Court reasoned, and because the transfer was "effected by court decree, no 'promise or agreement' of the parties" resulted.<sup>103</sup> Nevertheless, because payments pursuant to a divorce are not actually voluntary property agreements between the parties (which would be subject to gift tax) a transfer made pursuant to a court order, or a separation agreement that is subject to court redetermination, escapes gift tax liability.<sup>104</sup> In other words, the court order creates a legal obligation where one otherwise did not exist, and this legal obligation qualifies as adequate consideration. This is consistent with the gift tax purpose of preventing the tax-free diminution of one's estate through inter vivos transfers, a motivation that is clearly not present with these types of transfers. To illustrate, if the state imposes a legal duty to support one's minor children, a property transfer or the creation of a trust for that child "hardly depletes the transferor's estate any more so than would the furnishing of support for a minor child living with

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99. *Id.*

100. *Id.* § 2516(1).

101. *Id.* § 2516(2) (emphasis added).

102. 340 U.S. 106 (1950).

103. *Id.* at 111-12.

104. Schlissel & Skarlatos, *supra* note 27, at 89-90. Note, however, that payments made by the representative of an incompetent person *pursuant to a court order* may be subject to the gift tax. This seems contrary to the *Harris* opinion, but in fact this situation is distinguishable. Although the transfers are not voluntary, there is no legal duty to support in these situations. The court simply sees that a relative to the incompetent individual is in need and presupposes that the incompetent would have helped his relative if he had proper capacity to do so. See, e.g., Rev. Rul. 67-280, 1967-2 C.B. 349 (holding that moneys paid by the committee of an incompetent person to his relatives without consideration are subject to gift tax); Rev. Rul. 73-612, 1973-2 C.B. 322 (finding payments made by guardian from estate of incapacitated ward to a nondependent are subject to gift tax).



the parent.”<sup>105</sup> The real issue, however, is whether this *Harris* exception, which actually predates I.R.C. § 2516,<sup>106</sup> enlarges the scope of nonvoluntary tax-free transfers to include the rare occurrence of support payments to adult children pursuant to a divorce decree. While some argue that such payments are veiled in a nonvoluntary cloak and, therefore, are nontaxable,<sup>107</sup> the better view is that notwithstanding the nonvoluntary aspect of such transfers, a tax-free support obligation cannot eclipse that for which the transferor is liable under state law.<sup>108</sup> If this is the case, the *Harris* exception, like I.R.C. § 2516, adds little to existing law with respect to gift taxation of child support payments.

### III. THE CURRENT STATE OF THE LAW—AN ETHICAL DILEMMA FOR TAX ADVISORS

The current state of the law regarding transfers for the support of another leaves the tax advisor in an ethical bind. Clearly the Internal Revenue Code requires that gifts of money or tangible property that are made for the benefit of another should be reflected by the donor as a gift subject to gift tax. With almost as much clarity, albeit with a distinct sense of unfairness and with little knowledge even among the educated public, transfers for the support of another made out of a moral, but not legal, duty also constitute gifts subject to gift tax. The water takes on some turbidity, however, regarding the implication of the gift tax to those common familial transfers of property that involve only the *use* of property: for example, the uncompensated use of a parent's automobile by an adult child or the elderly mother who is

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105. Schlissel & Skarlatos, *supra* note 27, at 88 (quoting WILLIAM J. BROWN, 1 DIVORCE AND TAX PLANNING STRATEGIES § 13.09, at 13-10 (1992)).

106. *Harris* was decided in 1950 and I.R.C. § 2516 was enacted in 1954. Although § 2516 was enacted to bring some degree of certainty to the area, “it is well to observe that Section 2516 does not purport to be exclusive, and a divorce transfer that is not exempt under this section may still escape tax under general gift tax principles.” STEPHENS ET AL., *supra* note 74, at 10-79 (citing Michel G. Emmanuel, *Property Settlements: Ante-Nuptial, During Marriage, at Termination*, 24 N.Y.U. INST. ON FED. TAX’N 281 (1966)).

107. Hesch, *Divorce and Separation*, 95-5th Tax Mgmt. (BNA), at A-17 (1988).

108. *Weidmann v. Commissioner*, 26 T.C. 565, 569 (1956) (holding that value of remainder interest transferred to adult daughter pursuant to a divorce decree was a taxable gift); *Rosenthal v. Commissioner*, 205 F.2d 505, 508 (2d Cir. 1953) (“We do not find this [*Harris*] rationale applicable to a decree ordering payments to adult offspring . . . .”); Gen. Couns. Mem. 37,397 (Jan. 30, 1978) (“In addition, the mere fact that the promise or court order to provide for children may be enforceable by then [sic] does not necessarily mean that it is based on adequate consideration . . . .” (citations omitted)); *see also* Rev. Rul. 67-280, 1967-2 C.B. 349. From a public policy standpoint, it would hardly seem appropriate to impose gift tax on voluntary transfers to an adult child for support made pursuant to a moral obligation, but have nonvoluntary, court-ordered, support transfers escape tax.

provided rent-free accommodations in her child's house or in a dwelling owned by the child. More specifically, the Court's interpretation of I.R.C. § 2501 in *Dickman v. Commissioner*<sup>109</sup> did not decide the question of what common transfers must be reported as taxable gifts.

It is clear from the Code that nonsupport transfers of property or money that are made directly to another represent a gift subject to gift tax, and therefore the advisor must indicate such to the client. But what happens when the client begins to inform the advisor about payments made in direct support of another—a person whom the transferor/client has no legal obligation to support? The client begins to speak about money paid to an adult child in college, or money and property transferred to an aging parent. Does the advisor politely interrupt and say, "Before you tell me anything more about your situation, let me tell you about the gift tax rules. Did you know that transfers of money or property to another for that person's support may result in gift tax liability to the donor when there is no legal duty to support that person? Now that you know the rules, do you really want to divulge this information?" If the client insists on continuing, does the advisor insist that the client file gift tax returns if necessary?<sup>110</sup> Or does the advisor tell the client that, as ridiculous as it sounds, these support-type transfers are actually gifts subject to gift tax, but nevertheless the client would be a fool to report them as such because nobody else does and the IRS does not seem to be aggressively pursuing such transactions?

What of situations where the client merely allows an adult child or parent to live rent-free in the client's beach house, or exclusively use a car owned by the client. Recall that in *Dickman*, the Court said that a decision to treat an interest-free loan as a gift of property (the use of the property measured by the interest not charged) would give rise to the application of the gift tax when family members are provided with rent-free use of property.<sup>111</sup> The Court, while recognizing that it is common for parents to provide their adult children with such

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109. 465 U.S. 330 (1984); see discussion *supra* notes 55-63 and accompanying text.

110. A gift tax return must be filed by April 15 following the calendar year in which the gift was made. I.R.C. § 6075 (1988). This is necessary only when the gift exceeds the \$10,000 per donee annual exclusion. See *supra* note 33.

111. *Dickman*, 465 U.S. at 336-37. The petitioners argued that when carrying the Court's rationale for taxing interest-free demand loans to its logical extreme, such "commonplace transactions as a loan of the proverbial cup of sugar to a neighbor or loan of lunch money to a colleague" would technically become transfers subject to the gift tax. *Id.* at 341. Although the majority brushed over this contention, the dissent noted that the potential scope of the opinion was its most troublesome feature. *Id.* at 349 (Powell, J., dissenting). By not limiting the holding to interest-free loans, "the rent-free use of a home by a child over the age of minority who lives with his parents, or by a parent over the age of self-

things as the use of a car, "assumed" that "the focus of the Internal Revenue Service is not on such traditional familial matters."<sup>112</sup> Unfortunately, this assumption provides little guidance to the attorney who must advise the client. Should a client be told, "Don't report it and we will keep our fingers crossed that you don't get audited?" How would such behavior affect our tax system, which relies, primarily, on self-assessment? The uncertainty created by *Dickman* draws a fine line between sound legal advice and a breach of the ethical duties owed by the tax advisor.<sup>113</sup>

In all areas of advice, tax included, the advising attorney must protect the client's best interests and at the same time live up to the obligations imposed upon the legal profession. Obligations imposed upon the attorney when advising a client emanate from two major sources: the federal tax statutes, and federal and state rules of professional ethics.

A. *Statutory Obligations Imposed on Advisors to Ensure Tax Compliance*

The Internal Revenue Code imposes duties on attorneys and their clients to ensure compliance with the tax laws. First, I.R.C. § 6662 includes a penalty for negligence and disregard of the tax rules and regulations.<sup>114</sup> Although this accuracy-related penalty imposes a duty on the taxpayer, it also indirectly imposes a duty on the tax advisor because a lawyer's obligation flows from the client's responsibility to comply with the law.<sup>115</sup> Under I.R.C. § 6662, negligence includes any failure to make a reasonable attempt to comply with the revenue laws or to exercise ordinary and reasonable care in the preparation of a tax return.<sup>116</sup> In determining negligence, courts usually apply the "reasonably prudent" test, which requires that the taxpayer has a rea-

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support who lives with her child" becomes a transfer subject to possible tax liability. *Id.* at 350.

The dissent also acknowledged the valuation problem created by the possibility of taxation in these situations. *Id.* "It is often difficult to place a value on outright ownership of property. Those difficulties multiply when the interest to be valued is the use of the property for varying lengths of time." *Id.*

112. *Id.* at 341. The dissent recognized that "[t]his assumption is not likely to afford much comfort to taxpayers and the lawyers and accountants who advise them." *Id.* at 351.

113. Jean T. Adams, *Reconciling Family Law with Tax Policy: Untangling the Tax Treatment of Parental Trusts*, 46 TAX L. REV. 107, 108 (1990). The rules for advising clients in this area "seem to turn on formal distinctions, inviting manipulation of the tax outcome through artful drafting of trust instruments and separation agreements." *Id.*

114. I.R.C. § 6662 (1988 & Supp. V 1993). Any violation of § 6662 results in a penalty to the taxpayer of 20% of the portion of the underpayment. *Id.* § 6662(a).

115. J. Timothy Philipps, *It's Not Easy Being Easy: Advising Tax Return Positions*, 50 WASH. & LEE L. REV. 589, 598 (1993).

116. Treas. Reg. § 1.6662-3(b)(1) (1995).

sonable basis for a position taken on the tax return.<sup>117</sup> As long as the return position is arguable, it may satisfy the reasonably prudent requirement even if it is not likely to prevail in court.<sup>118</sup> A ten- to twenty-percent chance of success if litigated probably satisfies the reasonable basis standard.<sup>119</sup> In simple terms, the negligence penalty can be avoided if the taxpayer provides a reasonable basis for the tax position taken. The penalty also may be avoided if the taxpayer makes adequate disclosure of the position taken on the return.<sup>120</sup> Clearly, under existing law, the negligence penalty would attach to the nonreporting of direct transfers of money or property for an adult child's or parent's support. With respect to support-type use of property by another, however, the answer is not as clear. Conceivably, advising the client to clearly disclose the use of any property for the support of another may force the IRS's hand to pursue a gift tax liability, notwithstanding the Supreme Court's *assumption* to the contrary.

The second possible taxpayer penalty imposed by the Internal Revenue Code occurs when there is any substantial understatement on the tax return.<sup>121</sup> Section 6662(b)(5) specifically addresses transfers for the support of another by declaring a penalty for "[a]ny substantial estate or gift tax valuation understatement."<sup>122</sup> The Code defines "substantial valuation understatement" for the estate and gift tax as transfers where "the value of any property claimed on any return of tax imposed . . . is 50 percent or less of the amount determined to be the correct amount of such valuation."<sup>123</sup> Therefore, if the taxpayer does not report the support transfers, or reports them in an amount less than fair market value, he may be in violation of this section. As a result of these penalties imposed on individuals, if the IRS determines that the taxpayer made taxable gifts when he transferred property (or allowed the use of such property) for the support

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117. Philipps, *supra* note 115, at 599 (citing a number of cases in which courts applied the "reasonably prudent" test, e.g., *Heasley v. Commissioner*, 967 F.2d 116, 120-21 (5th Cir. 1992); *Sammons v. Commissioner*, 838 F.2d 330, 337 (9th Cir. 1988); *Marcello v. Commissioner*, 380 F.2d 499, 506 (5th Cir. 1967)).

118. Treas. Reg. § 1.6662-4(d)(2) (1995).

119. Sheldon Banoff & Harvey Coustan, *Final Regulations on Return Preparer Penalties: IRS Refuses to Deal, Preparers' Fears Prove to Be Real/Penalty Roulette—Roll the Wheel/Who Knows How the Courts Will Feel*, 70 TAXES 137, 175 (1992).

120. Treas. Reg. § 1.6662-3(c) (1991).

121. I.R.C. § 6662(b) (1988 & Supp. V 1993). As with the penalty for negligence, 20% of the amount underpaid is added to the tax owed. *Id.* § 6662(a).

122. *Id.* § 6662(b)(5).

123. *Id.* § 6662(g)(1). The Code also provides that if the misstatement of valuation is "gross," the penalty may increase from 20% of the underpayment to 40% of the underpayment. *Id.* § 6662(h)(1).

of another, the taxpayer may be liable for both negligence in not complying with the tax laws, and for substantial understatements on his tax return.

The Internal Revenue Code also imposes an obligation directly on the tax advisor. Section 6694 provides that any understatement of liability that is due to a position that lacks a realistic possibility of being sustained on its merits will result in a \$250 fine on the tax advisor.<sup>124</sup> A realistic possibility of success exists if "a reasonable and well-informed analysis would lead a person knowledgeable in the tax law to conclude that the position has approximately a one-in-three, or greater, likelihood of being sustained on its merits."<sup>125</sup> Specifically regarding the *Dickman* "use of property" type situations,<sup>126</sup> a tax advisor clearly can make an argument that there is a greater than one-in-three chance that the IRS will not *challenge* traditional familial transfers for support. However, if the IRS does challenge such transfers for support, the Code specifically requires a one-in-three chance that the position will be *sustained on its merits*. Because familial transactions such as the use of a parent's car by an adult son are technically gratuitous transfers of property as set forth by the holding in *Dickman*, the tax advisor may have trouble arguing successfully *on the merits* when these types of transfers have been excluded from the tax return. This is exactly the "lack of comfort position" for advisors that the dissent predicted in *Dickman*.<sup>127</sup>

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124. *Id.* § 6694(a) (1988 & Supp. V 1994). The Code reads as follows:

(a) Understatements due to unrealistic positions. -If-

(1) any part of any understatement of liability with respect to any return or claim for refund is due to a position for which there was not a realistic possibility of being sustained on its merits,

(2) any person who is an income tax return preparer with respect to such return or claim knew (or reasonably should have known) of such position, and

(3) such position was not disclosed . . . or was frivolous, such person shall pay a penalty of \$250 with respect to such return or claim unless it is shown that there is reasonable cause for the understatement and such person acted in good faith.

I.R.C. § 6694(a)(1)-(3). Additionally, if the understatement of liability is due to a "willful attempt in any manner to understate," or to "any reckless or intentional disregard of rules," the penalty is increased from \$250 to \$1000. *Id.* § 6694(b)(1)-(2).

A \$1000 penalty for "aiding and abetting" in the understatement of tax might also have implication to an advisor. See *id.* § 6701 (1988 & Supp. V 1993).

125. Philipps, *supra* note 115, at 608.

126. *Dickman v. Commissioner*, 465 U.S. 330, 336-38 (1984); see *supra* notes 55-63 and accompanying text.

127. The dissent in *Dickman* noted that the assumption that the IRS will not pursue such transfers is "not likely to afford much comfort to taxpayers and the lawyers and accountants who advise them." 465 U.S. at 351 (Powell, J., dissenting). "In short, the net result of the Court's decision will be to create potential tax liability for many taxpayers who have never

*B. Professional Obligations—Rules of Ethics for Attorneys*

In addition to the penalties set forth in the Internal Revenue Code, tax practitioners are also subject to state and federal ethics rules and to discipline thereunder.<sup>128</sup> Although courts adopt varying ethical rules,<sup>129</sup> the American Bar Association (ABA) *Model Rules of Professional Conduct*<sup>130</sup> and the Treasury Department's Circular 230<sup>131</sup> have become the unifying standards for tax practice.

Under the Model Rules, the attorney "may advise reporting a position on a return even where the lawyer believes the position probably will not prevail, there is no 'substantial authority' in support of the position, and there will be no disclosure of the position in the return."<sup>132</sup> However, a requirement of good faith is imposed on the advisor so that "there must be some realistic possibility of success if the matter is litigated."<sup>133</sup> This standard contemplates a likelihood of success of around one-third in order to qualify as a realistic possibility.<sup>134</sup>

Circular 230 mandates that the practitioner exercise "due diligence" in preparing and filing returns and other documents with the IRS.<sup>135</sup> This standard is met if there is a "reasonable basis" for the position.<sup>136</sup> Therefore, if the transfers for support satisfy the requirements of Formal Opinion 85-352 of the Model Rules, the Circular 230 standard also will be met.

When applying these professional standards to familial gifts such as allowing an adult child or relative to use a second home, car, airplane, boat, or other property rent-free, the issue becomes whether an effective argument can be made for a gift tax *not* being assessed. In

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been subject to it before, and create legal, tax accounting, and return filing nightmares for many others." *Id.* at 352.

128. Steven C. Salch, *Tax Practice Ethics: Practitioner Discipline and Sanctions*, C889 A.L.I.-A.B.A. 285, 288 (1993).

129. *Id.* The majority of state courts, the Tax Court, and the Claims Court use the ABA *Model Rules of Professional Conduct* or the predecessor ABA *Model Code of Professional Responsibility* as their ethical standard. The federal district courts and courts of appeals generally use either the state's ethics codes, the Model Rules, or a combination of the two. *Id.* at 288-89.

130. MODEL RULES OF PROFESSIONAL CONDUCT (1983).

131. 31 C.F.R. § 10.34 (1995).

132. ABA Comm. on Ethics and Professional Responsibility, Formal Op. 85-352 (1985), *reprinted in* 39 TAX LAW. 631, 633 (1986).

133. *Id.* at 634.

134. *Report of the Special Task Force on Formal Opinion 85-352, reprinted in* 39 TAX LAW. 635 (1986). The Task Force found that "[a] position having only a 5% or 10% likelihood of success, if litigated, should not meet the new standard. A position having a likelihood of success closely approaching one-third should meet the new standard." *Id.* at 638-39.

135. 31 C.F.R. § 10.34 (1995); *see also* Philipps, *supra* note 115, at 618.

136. Philipps, *supra* note 115, at 618.

*Dickman v. Commissioner*,<sup>137</sup> the Court used the plain-meaning approach and held that Congress intended "the gift tax statute [§ 2501] to reach *all* gratuitous transfers of *any* valuable interest in property."<sup>138</sup> Even though the Court *assumed* that Congress would not enforce the statute toward commonplace familial transactions, there is no authority that the advisor may rely on to warrant belief in a one-in-three likelihood of success on the merits after excluding such transfers from the tax return. If the Court is consistent in applying the plain meaning of the statute, the language of I.R.C. § 2501 clearly encompasses the use of a home, the use of a car, and the use of the "proverbial cup of sugar."<sup>139</sup>

On the other side of the coin, the tax advisor has an obligation to protect the client's best interests, not to mention the advisor's own moral obligation as a human being. (Unthinkable as it may seem, tax advisors are people too!) Can an advisor fulfill such obligations by looking a client in the eye and telling him he must pay a gift tax for providing his elderly parent with shelter, food, and clothing? Such advice discourages families from taking care of one another, which is clearly against public policy. Advising a client to report such transfers also results in an extra financial burden for the taxpayer who may be scraping together pennies just to provide support for the extra family member. If the Court can *assume* that the IRS will not focus on certain types of familial transactions, perhaps it is not too much to ask the IRS to provide an exclusion from gift tax for transfers for the support of another.

#### IV. TRANSFER-FOR-CONSUMPTION EXCLUSION—A MODEL FOR REFORM

Subjecting transfers for the support of others to a gift tax violates the core principles of human compassion and does not promote the general policy underlying the imposition of a gift tax.<sup>140</sup> In the gift tax arena, discharging one's moral obligation to support another should not be of any less weight than fulfilling one's legal support obligations. In addition, gift tax liability and the imposition of penalties should not depend upon the IRS's presumed policy of not enforcing the law on certain common familial transfers.<sup>141</sup> Presently,

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137. 465 U.S. 330 (1984).

138. *Id.* at 334 (emphasis added).

139. *Id.*

140. Again, the general purpose for the gift tax is to prevent individuals from intentionally diminishing their estates through inter vivos transfers in order to escape estate tax liability. See *supra* notes 25-27 and accompanying text.

141. See Ray, *supra* note 13, at 426-27.

transfers for the benefit of persons dependent on the transferor are taxable to the extent they exceed the annual exclusion and are not in discharge of one's legal obligation.<sup>142</sup> Nonetheless, it is difficult for a taxpayer to understand why support given to a public charity results in zero tax liability<sup>143</sup> while support given to a needy friend or relative is subject to a gift tax. In fact, most transferors simply do not regard payments for clothing, food, and shelter to their loved ones as taxable gifts.<sup>144</sup> Perhaps as a result, not only has the IRS apparently taken a position of nonenforcement, but the public itself has unknowingly taken a position of noncompliance.<sup>145</sup>

It is time to reexamine the purpose of the gift tax and its application to transfers for support. The purpose of the gift tax, to act as a backstop to the estate tax,<sup>146</sup> is not in harmony with the motivation behind transfers made for another's support. In 1981 Congress took a step in the right direction by enacting gift tax exclusions for certain support-related transfers. Unfortunately, these provisions do not adequately deal with the transfer-for-support issue. Following is a discussion of these provisions and a proposal for a more thorough solution.

*A. A Step in the Right Direction—The Existing Educational and Medical Expense Exclusion*

In 1981 Congress responded to the injustice of taxing certain payments for support by providing an unlimited exclusion for certain medical and educational expenses paid for the benefit of another. Section 2503(e) reads as follows:

(1) In general

Any qualified transfer shall not be treated as a transfer of property by gift for purposes of this chapter.

(2) Qualified transfer

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142. Harry L. Gutman, *A Comment on the ABA Tax Section Task Force Report on Transfer Tax Restructuring*, 41 TAX LAW. 653, 660 (1988); see also *supra* notes 33, 74-76 and accompanying text (discussing transfers to dependent transferees).

143. In computing taxable gifts for the calendar year, § 2522 allows a deduction for transfers made to charitable organizations regardless of the amount. I.R.C. § 2522(a) (1988). Similarly, when determining estate tax liability, a deceased individual's bequests of property to charity are deducted from the gross estate. *Id.* § 2055(a). In addition to these deductions from the estate and gift tax, the transferor also receives an income tax benefit, subject to limitations. *Id.* § 170(a), (b)(1)(A)-(B).

144. Gutman, *supra* note 142, at 660.

145. See *supra* notes 11-12 and accompanying text.

146. See *supra* notes 24-27.



For purposes of this subsection, the term "qualified transfer" means any amount paid on behalf of an individual—

(A) as tuition to an educational organization . . . for the education or training of such individual, or

(B) to any person who provides medical care . . . with respect to such individual as payment for such medical care.<sup>147</sup>

This exclusion is available for payments made on behalf of any individual, regardless of his relationship to the transferor, as long as the payment is made directly to the provider of the services.<sup>148</sup> The exclusion is in addition to the \$10,000 annual gift tax exclusion.<sup>149</sup> To qualify for the educational and medical exclusion, the support can only be for direct medical expenses<sup>150</sup> and tuition; hence the cost of books, supplies, board, and meals while attending school does not qualify under section 2503(e).<sup>151</sup>

Clearly, enactment of I.R.C. § 2503(e) indicates some recognition by Congress that certain transfers should not fall within the scope of the gift tax. The two items impacted by the statute, education and medical costs, are among those typically included within the spectrum of support-related expenditures. The fact that this gift exclusion applies notwithstanding any legally imposed obligation of support indicates that many support-type transfers are now free from gift tax. Payments for an adult child's education still lack consideration in money or money's worth, but as long as these payments are made directly to an institution for the requisite tuition and fees, they will be

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147. I.R.C. § 2503(e) (1988).

148. Treas. Reg. § 25.2503-6 (1984). The regulation specifically states that if the transferor reimburses the individual in need of support rather than making payments directly to the provider of the services, the payments do not qualify under the exclusion. *Id.* § 25.2503-6(c), ex. 4. In applying § 2503(e), the IRS addressed a situation in which an adult child was seriously injured in an automobile accident. Rev. Rul. 82-98, 1982-1 C.B. 141. While the child was incapacitated, his father paid his medical expenses directly to the hospital, and also made monthly mortgage payments on the adult child's house. *Id.* The IRS allowed an exclusion for the medical expenses because they were paid directly to the hospital, but disallowed any exclusion for the mortgage payments because they did not fall under § 2503(e). *Id.*

149. Treas. Reg. § 25.2503-6(a). The \$10,000 annual exclusion from the gift tax for each donee is provided in I.R.C. § 2503(b). *See supra* note 33.

150. Qualifying medical expenses are defined in § 213(d) and include "expenses incurred for the diagnosis, cure, mitigation, treatment or prevention of disease." Treas. Reg. § 25.2503-6(b)(3). In addition, the exclusion covers payments made for medical insurance on behalf of any individual. *Id.* However, amounts paid for medical care that are reimbursed by the donee's insurance are not excluded from taxable income. *Id.*

151. *Id.* § 25.2503-6(b)(2). The unlimited exclusion only applies to tuition for full-time or part-time students paid directly to the educational institution. *Id.*

excluded from becoming taxable gifts via I.R.C. § 2503(e).<sup>152</sup> Similarly, qualifying medical payments made on behalf of another escape the wrath of the gift tax.<sup>153</sup>

Although I.R.C. § 2503(e) excludes from the gift tax many typical transfers made for the support of another, it falls short of providing an all-encompassing solution to the problem. Section 2503(e), by default, acknowledges the taxability of transfers that fall outside the listed exceptions, such as support other than educational and medical expenses not required under local law (for example, support of an adult child). Still vulnerable are those support-type transfers made to, or for, the benefit of a nondependent adult child or parent. For example, general living, transportation, and nonqualifying educational or medical payments are among those types of transfers that may still subject the transferor to gift taxes.

If the purpose of I.R.C. § 2503(e) is to exclude expenditures for support and address the problem of nonenforcement and noncompliance, restricting the exclusion to tuition and direct medical expenses leaves much to be desired.<sup>154</sup> The rationale for the unlimited educational and medical expense exclusion for nondependents should logically extend to other payments for support of nondependents.<sup>155</sup>

### *B. The Need to Go Further—The Transfer-for-Consumption Exclusion Proposal*

This Article proposes that transfers for the support of another individual, arising from one's legal or moral sense of obligation, should not subject the transferor to gift tax. Accomplishing a desirable societal objective (or perhaps more appropriately, not penalizing socially desirable behavior) through tax legislation can be a daunting task. No tax provision has such a "bright line" as to not create problems with interpretation or enforcement. Nevertheless, a workable proposal for excluding support-type transfers does exist.

In 1969 the American Law Institute (ALI) proposed an exclusion for transfers made for another's consumption, and in 1977 the ALI recommended that such an exclusion be included in the then-current

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152. *Id.* § 25.2503-6(c), ex. 1.

153. *Id.* § 25.2503-6(c), ex. 3.

154. Gutman, *supra* note 142, at 661.

155. K. Jay Holdsworth et al., *Report on Transfer Tax Restructuring*, 41 TAX LAW. 395, 402 (1988). However, the authors conclude that due to the potential for abuse, the exclusion should not be extended to cover support payments for nondependents other than for educational and medical expenses. *Id.*

estate and gift tax reform measures.<sup>156</sup> Unfortunately, the ALI's "transfer-for-consumption" exclusion was not adopted. The text of the ALI proposal reads as follows:

An expenditure should be excluded from transfer taxation as a lifetime transfer, under either a dual tax system or a unified tax, if the expenditure is for:

(a) the benefit of any person residing in the transferor's household, or the benefit of a child of the transferor under 21 years of age, whether or not he resides in the transferor's household, provided that such expenditure does not result in such person or child acquiring property which will retain significant value after the passage of one year from the date of such expenditure; or

(b) current educational, medical or dental costs of any person, or

(c) current costs of food, clothing and maintenance of living accommodations of any person in fact dependent on the transferor, in whole or in part, for support, provided such expenditures are reasonable in amount.<sup>157</sup>

The ALI proposal does not, directly, predicate a gift exclusion on fulfillment of any moral or legal obligation regarding support. Rather, the premise for the exclusion rests on the foundation for estate and gift taxes: a tax on the privilege of transferring wealth. Quite logically, when wealth is consumed, it is no longer wealth. Clearly, wealth consumed for an individual's own benefit is not a transfer for gift tax purposes<sup>158</sup> nor does it remain as part of his estate at death for estate tax purposes.<sup>159</sup> If we were to view certain related or otherwise close individuals as being one family unit, or pseudo-individual, then inter vivos transfers of assets to any member of this group for such

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156. Ray, *supra* note 13, at 446 (citing Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (codified as amended in scattered sections of 26 U.S.C.)). The recommendations of the American Law Institute made it all the way to the House Committee on Ways and Means before it was defeated. *Id.*

157. AMERICAN LAW INST., RECOMMENDATIONS FOR FEDERAL ESTATE AND GIFT TAXATION 19, 20-21 (1969) [hereinafter ALI PROPOSAL].

158. The receipt of services or property (which is subsequently consumed) in exchange for transfers of wealth, must constitute consideration in money or money's worth. *See supra* notes 35-50 and accompanying text (discussing valid consideration for gift tax purposes).

159. The gross estate includes the value of all property, wherever situated, that the decedent had an interest in *at the time of death*. I.R.C. § 2031(a) (1988). This includes the amount of cash belonging to the decedent at the date of death. Treas. Reg. § 20.2031-5 (1958). However, any amount of cash the decedent consumed for self-support prior to death is excluded from the estate. This result is quite logical because amount of wealth consumed does not give rise to any valuable asset and cannot be transferred to the decedent's heirs. *Id.*

member's consumption would likewise be excluded.<sup>160</sup> The ALI proposal effectively does just this.

One can also argue that the imposition of a gift tax on the transfer of wealth contemplates the transfer of sustained wealth and not just any transfer of assets.<sup>161</sup> When property is transferred for another's consumption it cannot, by default, be a transfer of sustained wealth. It follows, therefore, that such inter vivos transfers should not be subject to gift taxes. The ALI's 1968 transfer-for-consumption proposal seeks to exclude these types of transfers from the gift tax, and provides a workable model for gift tax reform. An analysis of the ALI proposal vis-a-vis transfers for another's support follows.

1. *No Transfers of Sustained Wealth.*—The ALI proposal contemplates an exclusion for transfers to certain individuals. The categories of permissible transferees (and any transferee-specific transfer restrictions) are addressed later, but a key component of the ALI proposal relates to the nature of the transfer. Only transfers to qualifying individuals that are not transfers of sustained wealth can be excluded from the gift tax. In describing one category of excluded transfers, the proposal states: "[Transfers shall be excluded] provided that such expenditure does not result in [the transferee] . . . acquiring property which will retain any significant value after the passage of one year from the date of . . . [such transfer]."<sup>162</sup> This is the consumption na-

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160. The "pseudo-individual" includes any person residing in the transferor's household, a child of the transferor under 21 years of age, an individual for whom the transferor is providing educational, medical, or dental costs, and any person dependent on the transferor, in whole or in part, for support. ALI PROPOSAL, *supra* note 157, at 20-21.

161. This concept is consistent with the historical estate tax justification of preventing the accumulation of wealth in a limited number of families. In 1906 President Theodore Roosevelt expressed that "the prime objective [of taxing an estate] should be to put a constantly increasing burden on the inheritance of those swollen fortunes which it is certainly of no benefit to this country to perpetuate." BITTKER & CLARK, *supra* note 3, at 3-4 (quoting 17 WORKS OF THEODORE ROOSEVELT 434 (1925)). Andrew Carnegie supported this rationale and said,

Men who continue hoarding great sums all their lives, the proper use of which for public ends would work good to the community from which it chiefly came, should be made to feel that the community, in the form of the State, cannot thus be deprived of its proper share.

*Id.* (quoting ANDREW CARNEGIE, THE GOSPEL OF WEALTH 21-22 (1962)). In addition, modern theorists recognize that the estate tax plays a significant role in the distribution of the overall tax burden, and helps to maintain progressivity in the federal tax system. *Id.* at 6.

162. ALI PROPOSAL, *supra* note 157, at 20-21. This "one-year" language appears only with respect to the first category of qualified transferees, any person living with the transferor or the transferor's child under the age of 21. *Id.*; see also *infra* notes 174-179 and accompanying text. Curiously, in the discussion draft of the ALI's proposal, the "one-year" requirement applied not only to this first category of qualified transferees, but also applied to those transferees dependent in whole or in part on the transferor for support. AMERICAN

ture of the proposal. It effectively confirms the notion that an *inter vivos* transfer for another's consumption is not an attempt by the transferor to transfer sustained wealth to another individual and deplete the transferor's estate, thereby escaping the estate tax.<sup>163</sup> When wealth is merely consumed and not transferred, the gift tax's role as a backstop to the estate tax is not implicated.<sup>164</sup>

To be considered for this exclusion, therefore, property transferred must be consumed by the transferee—with no lingering wealth remaining in the transferee's hands.<sup>165</sup> Assuming the transferee fits a qualifying profile,<sup>166</sup> transfers of money for such items as the transferee's food and lodging would clearly come within the exclusion: current costs, where wealth would almost immediately be consumed, resulting in no retention of an asset with value one year after the transfer. A clear example of a transfer not coming within this exclusion is a transfer, in fee, of a house. While arguably it is a transfer

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LAW INST., FEDERAL ESTATE AND GIFT TAX PROJECT, DISCUSSION DRAFT OF RECOMMENDATIONS 17, 19 (1968) [hereinafter ALI PROPOSAL DRAFT]. In the proposal draft, the one-year requirement specifically was not applicable to transfers for educational, medical, or dental costs. *Id.* at 19. The omission of this one-year requirement to all categories of transfers enumerated in the final ALI proposal is, most likely, of little consequence however. The proposal's use of the word "current" with respect to educational, medical, dental, and support expenditures, connotes a transfer of property that is consumed in the near term, consistent with a one-year requirement. ALI PROPOSAL, *supra* note 157, at 20-21.

163. The logic of "for-consumption" transfers could conceivably extend to testamentary transfers: a transfer of property that is consumed by the testamentary beneficiary within a short period of time after the decedent's death. However, this would not be an appropriate extension because the focus of a for-consumption exclusion is only on those lifetime transfers that do not otherwise defeat the estate tax by depleting one's estate by predeath transfers of wealth. Denial of such a for-consumption exclusion for estate tax purposes is also consistent with the fact that the estate tax provisions are void of any I.R.C. § 2503-type exclusions. "The proposal as to transfers for consumption is applicable only to lifetime transfers. The considerations behind the proposal do not carry over significantly to death-time dispositions. This, of course, is also true of the annual per-donee exclusion which is not available with respect to death-time transfers." ALI PROPOSAL, *supra* note 157, at 20-21.

164. See *supra* notes 25-27 and accompanying text.

165. Curiously, the ALI proposal discussion draft did not contain the prohibition of transferring sustained wealth (specific exemption from the "retention of significant value beyond one year" requirement) with respect to transfers for educational or medical purposes. ALI PROPOSAL DRAFT, *supra* note 162, at 19. The proposal draft did, nonetheless, require that transfers for such purposes be for "current costs." *Id.* The two signals seem to point in different directions. The final proposal also contains this current cost requirement, which would seem to effectively preclude the transfer of sustained wealth. See *supra* note 162.

166. The ALI proposal requires that for the exclusion to apply to transferees other than the transferor's child under the age of 21 or someone residing in the transferor's household, the transfer must either be for "educational, medical or dental costs," or "food, clothing and maintenance of living accommodations" that must be "reasonable in amount." ALI PROPOSAL, *supra* note 157, at 21; see also *infra* notes 174-194 and accompanying text (discussing different classes of permissible transfers and transferees).

providing lodging to the transferee, it also results in the transfer of sustained wealth and not merely current costs because the house retains substantial value beyond one year.<sup>167</sup>

The ALI transfer-for-consumption exclusion also works very well in the *Dickman* use-of-property type situations. The use of property itself, as contrasted to outright transfer of ownership, represents consumption and nothing more.<sup>168</sup> If, as the court in *Dickman* stated, giving someone the use of property is itself the transfer of a valuable property right (the use thereof), then such a transfer would, nonetheless, be excluded from gift tax under the transfer-for-consumption proposal if other requirements of the exclusion are met.<sup>169</sup> Assuming the transferee is not granted use of the property for a specified term exceeding one year (such as a term of years or life interest),<sup>170</sup> no sustained or lingering wealth has been transferred.<sup>171</sup>

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167. It would seem that the determination of whether a cost is a current cost or an asset that will have significant value after one year must be made at the time of the gift. This would mean that events subsequent to the transfer that have an effect on the length of sustained value would be disregarded. The IRS would, of course, be suspicious of an initial determination of no substantial value beyond one year (and, therefore, no gift) when the transferred asset, in fact, does retain substantial value beyond the year. This idea is consistent with the proposition regarding valuation of gifts in general where the determination of value is made at the time of the gift based upon all known facts and circumstances and unexpected events subsequent to the transfer are ignored (i.e., a revaluation is not appropriate). In the words of the IRS, "if a gift is made in property, its value at the *date of the gift* shall be considered the amount of the gift." Treas. Reg. § 25.2512-1 (as amended in 1992) (emphasis added).

While the IRS might suffer an occasional loss of a gift tax opportunity, taxpayers also could be harmed by a valuation that, in hindsight, proves to have been too optimistic. For example, if a taxpayer, at the time of transfer, determines that the asset transferred will have substantial value beyond one year, the transfer will be precluded from exclusion under this transfer-for-consumption proposal. Should the asset, in fact, not retain substantial value beyond the year (i.e., be consumed), the subsequent events that caused the decline should be given no effect and no gift tax relief should be granted.

168. "Use" means only the *current use*, without granting use for a prescribed length of time (beyond one year). This must be distinguished from granting another a life or termed interest in property (beyond one year)—in which case the value of such interest, measured pursuant to tables prescribed by the Secretary of the Treasury, I.R.C. § 7520 (1988), constitutes a gift, not within the transfer-for-consumption exclusion.

169. The other requirements include a proper transferee and a proper amount of support depending on the relationship between the transferee and the transferor. See *infra* notes 174-194.

170. An interesting question is whether the value of the first year of a term of years or life interest could be considered "consumption" and therefore be excluded under the proposal.

171. In *Dickman*, the taxpayer was liable for a gift tax with respect to the value of the interest-free use of money that the taxpayer had loaned to his adult son. *Dickman v. Commissioner*, 465 U.S. 330, 338; see also *supra* notes 55-63 and accompanying text (discussing *Dickman*). This interest was valued as the amount of interest that should have been charged but was not. *Dickman*, 465 U.S. at 336-37. Subsequent to the *Dickman* decision, the

The cornerstone of the ALI proposal is the exclusion for transfers of wealth that are consumed by a transferee within a short period.<sup>172</sup> It is not, however, a blanket exclusion for all such for-consumption transfers to any transferee. The ALI proposal predicates the exclusion upon the identity of a transferee and the purpose of the transfer.<sup>173</sup> The categories of excluded transfers under the ALI proposal encompass what would normally be considered within the realm of legal or moral support obligations.

2. *Expenditures for Transferor's Children and Persons Residing in Transferor's Household.*—The first exclusion category under the ALI proposal is for expenditures made for “the benefit of any person residing in the transferor’s household, or the benefit of a child of the transferor under 21 years of age, whether or not he resides in the transferor’s household.”<sup>174</sup> By and large, the latter category of expenditures for children of the transferor under twenty-one adds little to current law. Expenditures for the benefit of a *minor* child that do not retain substantial value beyond one year are, most likely, support-type expenditures that, under current law, are not gifts because the discharge of a legal support obligation is considered adequate consideration.<sup>175</sup> To the extent a state obligation ceases at age eighteen,

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concept of taxing interest-free demand loans has been codified in I.R.C. § 7872 (1988 & Supp. V 1993). For purposes of this section, the term “loan” includes any “extension of credit or any transaction under which the owner of money permits another person to use the money for a period of time after which the money is to be transferred to the owner or applied according to an agreement with the owner.” Prop. Treas. Reg. § 1.7872-2, 50 Fed. Reg. 161 (1985).

If the ALI proposal is adopted, I.R.C. § 7872 will have to be dealt with to the extent it conflicts with the proposal’s exclusion for support-related transfers. Under the proposal, the use of money could be an excludable transfer if it was for a qualifying purpose and transferred to a qualifying transferee. This would require either the elimination of I.R.C. § 7872 in such instances or, in the alternative, the retention of the section and loss of exclusion in cases where the use of money is involved.

172. For a further discussion of the one-year and current costs requirements, see *supra* notes 162, 165, 167.

173. See *infra* notes 174-194 and accompanying text.

174. ALI PROPOSAL, *supra* note 157, at 20-21.

175. See *supra* notes 80-82 and accompanying text. The contrary, however, is not true. Not all categories of nontaxable gifts associated with support-type transfers would come within the ALI’s exclusion proposal. An example would be the transfer of an automobile, in fee, to a minor child of the transferor. The transfer of the automobile in exchange for the discharge of the transferor’s support obligation to provide transportation might be considered the receipt of adequate consideration in money or money’s worth, resulting in no gift subject to gift tax. See *supra* notes 74-79 and accompanying text; see also *supra* notes 90-95 and accompanying text (discussing when transfers might exceed the legal obligation of support). Viewed solely within the auspices of the ALI proposal, however, such a trans-

however, the ALI proposal conceivably extends, for three years, possible tax-free transfers to a child.<sup>176</sup>

The ALI proposal's exclusion for expenditures for persons other than children who reside in the transferor's household does, however, broaden current law. Qualifying expenditures for *any* person residing in the transferor's household are excluded transfers under the ALI proposal. This class of persons clearly can include any family member such as a parent, sibling, and the like, but can also include friends and other nonrelatives. Transfers to such individuals, again most likely within the context of what would be considered support related, would be excluded as long as the transferee was residing in the transferor's household. Under current law, such transfers would most likely be considered gifts because the transfers would be arising from a morally, as opposed to a legally, imposed obligation to support.<sup>177</sup>

The *Dickman* use-of-property concept should also be considered a qualifying expenditure or transfer with respect to consumption.<sup>178</sup> Therefore, the use of the transferor's property by a minor child or anyone residing in the transferor's household would be exempt from gift tax.<sup>179</sup> This provision takes care of many questionable *Dickman*-type gift issues under current law: the adult son living in his old bedroom back home, and the niece who lives with her uncle and is allowed to use his car.

*3. Expenditures for Current Educational, Medical, and Dental Costs.*—The second exclusion category under the ALI proposal is for expenditures made for “current education, medical or dental costs of

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fer would not be an excluded gift because of an automobile's retention of value beyond one year.

The proposal would, however, appear to address the issue, under current law, of transfers that exceed the transferor's legal obligation for support. See *supra* notes 90-95 and accompanying text. Under the proposal, varying levels of consumption (even well beyond that of required support) could, nonetheless, fall within the exclusion because there would be no retention of significant value beyond one year.

176. Interestingly, the ALI's proposal discussion draft used the term “minor child” instead of “a child of the transferor under the age of 21.” ALI PROPOSAL DRAFT, *supra* note 162, at 19.

177. Typically, there is no legal obligation to support unrelated individuals or family members other than minor children. See *supra* notes 80-88 and accompanying text. Note that excluded transfers under this category of the ALI proposal require only that a qualified child transferee reside in the transferor's household. It does not require that such transferee in any way be dependent upon the transferor for support. See *infra* notes 186-193 and accompanying text (discussing transfers to persons who are so dependent, but do not live with the transferor).

178. See *supra* notes 55-63 and accompanying text.

179. The possible exception might come under a retention of current I.R.C. § 7872 with respect to the use of money. See *supra* note 171.



any person."<sup>180</sup> The crux of this component of the ALI proposal has been codified in the gift tax exclusion found in I.R.C. § 2503(e).<sup>181</sup> There are, however, some differences between the two provisions. Recall that the existing exclusion provided by I.R.C. § 2503(e) for medical and educational costs requires that qualifying transfers be made directly to the provider of such services (for example, to the school, hospital, or doctor). Currently no exclusion covers transfers made to the transferee that are then used by the transferee for educational or medical purposes.<sup>182</sup> The ALI proposal does not appear to predicate the exclusion on direct payments to providers. Another possible area of divergence is the scope of excluded educational costs. The exclusion under I.R.C. § 2503(e), with respect to educational costs, is limited to tuition and does not include related costs such as books and supplies.<sup>183</sup> There is no specific language in the ALI proposal that limits educational costs to tuition only.<sup>184</sup> The broader exclusion of education and medical expenditures under the ALI proposal is preferable to the current I.R.C. § 2503(e) exclusion.<sup>185</sup>

4. *Expenditures for Support and Maintenance for Dependent Transferees.*—The third and final exclusion category under the ALI proposal is for expenditures made for "current costs of food, clothing and maintenance of living accommodations of any person in fact dependent on the transferor, in whole or in part, for support, provided such expenditure is reasonable in amount."<sup>186</sup> This category of exclusion is limited in both the scope of qualifying expenditures and the class of individuals to whom, or on whose behalf, such expenditures can be made.

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180. ALI PROPOSAL, *supra* note 157, at 21.

181. For a discussion of this exclusion, see *supra* notes 147-155 and accompanying text.

182. See, e.g., Treas. Reg. § 25.2503-6(b)(3), ex. 3 & 4 (1984).

183. *Id.* § 25.2503-6(b)(2).

184. While the ALI proposal does not specifically identify or define the scope of excluded educational costs, given the broad application of the exclusion in its entirety, it is logical that the drafters envisioned the application to be broader than current I.R.C. § 2503(e). Even if the exclusion for educational costs was not intended to be broad in scope, most costs tangential to education (even including room and board) could come within the purview of the proposal's other categories of exclusion. See also *infra* notes 186-194 (discussing the third category of exclusion for those dependent on transferor).

185. I.R.C. § 2503(e) should be expanded to cover educational costs in addition to tuition, such as books and supplies. If this were done, the rule requiring payment directly to the provider of the services could also be relaxed. This change would allow the taxpayer to reimburse the donee for any expenses incurred with respect to the donee's medical and educational needs. See also Holdsworth et al., *supra* note 155, at 402.

186. ALI PROPOSAL, *supra* note 157, at 21.

The scope of qualifying expenditures is limited to reasonable amounts for food, clothing, and maintenance of living accommodations.<sup>187</sup> While perhaps not broad enough to encompass all possible support-type payments, it does cover what most people consider to be the core components of support.<sup>188</sup>

The class of individuals to whom, or on whose behalf, such food, clothing, and shelter expenditures can be made is, again, not limited to family members nor, in this category, to individuals residing in the transferor's household.<sup>189</sup> Such expenditures for *any person* qualify for exclusion as long as the person is "dependent on the transferor, in whole or in part, for support."<sup>190</sup> This category, too, does not necessarily, and in fact probably does not, coincide with any legally imposed duty to support.<sup>191</sup> What it does require is that there be some degree of dependency on the transferor for support. There is nothing in the ALI proposal that suggests the basis for determining whether an individual is dependent upon another for support. Nevertheless, the proposal's requirement that the transferee be dependent on the transferor only in part for support, connotes a fairly broad interpretation of excludable expenditures.<sup>192</sup> It is logical to assume that an individual transferee facing severe financial hardship would be dependent on others for support, and thus dependent in whole or in part on qualifying transfers (food, clothing, or shelter) made by the transferor. Exactly what constitutes dependency on another for support for purposes of this exclusion, however, is not clear.<sup>193</sup>

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187. *Id.*

188. Reasonableness is, of course, a subjective determination based upon facts and circumstances. One must wonder whether the standard for reasonableness is coextensive with state-law-based levels of support.

189. If a transferee is residing in transferor's household, the expenditure might also qualify under the first category of qualifying expenditures. Residence in the transferor's household also enlarges qualifying expenditures to include items beyond food, clothing, and shelter. In addition, under the first category, there is no requirement that transferee be dependent upon transferor for support. See *supra* notes 174-179 and accompanying text.

190. ALI PROPOSAL, *supra* note 157, at 20-21.

191. *Id.*

192. The drafters surely did not contemplate such determination of dependency to be so restrictive as to be limited to situations where a state-determined obligation of support is found.

193. For example, in order to qualify, must the transferee be a "dependent" as defined for income tax purposes requiring that another provide more than half of his total support? See I.R.C. § 152 (1988). Can a transferee qualify even though not dependent on another for general support but dependent only with respect to the particular transfer? The latter interpretation appears to correspond to the proposal's requirement that the transferee need only be dependent "in part" on the transferor. Determination of dependency, on a transfer-by-transfer basis, however, would be difficult and might prove imprac-

This last category of excludable expenditures also covers the *Dickman* use-of-property scenarios.<sup>194</sup> The use of property would be an excludable transfer as long as it related to food, clothing, and shelter, and the transferee met the aforementioned dependency requirements.

The ALI's proposal for a transfer-for-consumption exclusion is a viable model for gift tax reform. Although enactment of I.R.C. § 2503(e) was a step in the right direction, limiting the exclusion to direct medical expenses and tuition still leaves the donor with a possible tax liability for support transfers. Adoption of the transfer-for-consumption proposal, in some form, is necessary to completely exclude certain transfers of support from the donor's taxable gifts.

The proposal as set forth is not free from problems. The ALI itself noted that

[a] "transfer-for-consumption" exception may raise some difficult factual issues in borderline situations, but most situations will fall clearly on one side of the line or the other. The creation of the difficult borderline area is justified to accomplish the larger benefit of excluding [from the gift taxation] typical transfers that are motivated by considerations other than the build-up of wealth in the transferee.<sup>195</sup>

As an alternative means to avoid tax on transfers for support, some commentators have suggested merely changing the donor's annual exclusion from \$10,000 per year, per donee,<sup>196</sup> to some greater amount such as \$30,000 per year per donor.<sup>197</sup> This, however, does not seem appropriate.<sup>198</sup> Increasing the annual exclusion may benefit those individuals who are actually making otherwise taxable gifts that

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tical. Adopting the income tax determination of dependency would provide some degree of certainty, although it might constrict this dependency category of gift tax exclusion.

194. See *supra* notes 55-63 and accompanying text.

195. ALI PROPOSAL, *supra* note 157, at 20.

196. See *supra* note 33.

197. Joint Committee on Taxation Staff Estimate of Administration Proposal for Reduction in Taxes on Capital Gains of Individuals, Daily Rep. for Execs. (BNA), Tax'n, Budget and Acct. Text (Feb. 15, 1990). Changing the exclusion to \$30,000 per donor, it is argued, will prevent donors with many donees (for whom the donor would receive a \$10,000 per donee exclusion under current law) from escaping the gift tax on a large scale. Holdsworth et al., *supra* note 155, at 401.

198. Increasing the \$10,000 amount subjects the annual exclusion to potential abuse. Ten thousand dollars per donee is more than adequate to cover customary gifts. However, many donors disregard these customary gifts in their computation and use the \$10,000 exclusion for a tax-saving device in their financial plan. Steinkamp, *supra* note 25, at 171. "By limiting the exclusion to \$10,000 in current dollars, approximately one-third of the potential for such abuse will have been eliminated as a result of inflation since 1981." *Id.*

should be subject to tax and, perhaps, might not be sufficient to cover the amount of transfers made for actual support.<sup>199</sup>

### CONCLUSION

Currently, for gift tax purposes, gifts are determined by objective, and arguably inimical, criteria: the transferor's receipt of consideration in money or money's worth. Transfers discharging a state-imposed *legal* obligation of support, such as that required for a minor child, meet this criteria. However, where the support of another individual stems not from a legal obligation, but a moral one, gift tax issues loom prominently.

The purpose of the gift tax is to act as a backstop to the estate tax: to prevent the tax-free, inter vivos transfer of wealth, and diminution of an estate. Transfers for the support of an adult child or elderly parent are motivated not by tax avoidance, nor by any legal obligation. Rather, they originate from an individual's moral conscience—to take care of a loved one in need. It is unlikely that Congress intended to tax those transfers wherein the donor is merely giving financial support that is typically provided in a normal familial relationship. Even so, without adequate consideration, support transfers are taxable gifts under current law regardless of the donor's selfless intention.

Subjecting transfers for the support of others to the gift tax violates the core principles of human compassion and does not promote the general policy for the imposition of a gift tax. In the gift tax arena, discharging one's moral obligation to support another should not be of any less weight than fulfilling one's legal support obligations. Exhibition of the most admirable and honorable of human traits should not be penalized by the imposition of a gift tax.

Notwithstanding public policy questions regarding the imposition of gift taxes to support transfers, there are many practical concerns with the current law. The general public is engaged in mass, albeit unintentional, noncompliance with the law. Unless confronted with support-type transfers, it appears that the IRS is reluctant to actively enforce the law. Gift tax liability and the imposition of penalties with respect to certain common familial transfers should not depend upon the IRS's presumed policy of nonenforcement. In addition, the tax advisor is placed in an uncomfortable position, both ethically and legally, when a client reveals the existence of such support-type trans-

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199. There is already ample argument that the use of the current annual exclusion is eclipsing its intended purpose and borders on being a sham. See generally Dora Arash, *Crummey Trusts: An Exploitation of the Annual Exclusion*, 21 PEPP. L. REV. 83 (1993).

fers. Current gift tax law does provide a limited exclusion from gift tax for certain transfers made for another's educational and medical needs, as well as a \$10,000 per year (per donee) exclusion. These, however, are not adequate to address the many other support-related transfers that should not be subject to gift tax, but in fact, are.

The ALI proposal for a transfer-for-consumption exemption should serve as a model for gift tax reform. This proposal effectively eliminates from gift tax those transfers to a logical class of permissible transferees that are not transfers of sustained wealth. Wealth that is consumed, by an individual or those in some relationship with that individual, is not a transfer of wealth at all and should not be considered a taxable gift. Individuals fulfilling their moral obligation to support a loved one should not bear the burden of gift taxes, and it is appropriate for Congress to rectify the situation.